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INCOME TAX ON GAINS AND LOSSES IN LITIGATION†

WILLIAM T. PLUMB, JR.*

2. Defendants

a. Disputed receipts

A client entered the office of Attorney John Smith¹⁶⁶ and showed him a summons which had just been served upon him in connection with a title dispute. After discussing the case for some time, the client's thoughts inevitably turned to his income tax.

"Mr. Smith," he asked, "I'm earning a substantial income from this property which the plaintiff is claiming, and if I lose the suit it will all be taken from me. Do I have to pay an income tax on it in the meanwhile, and if so what will be the effect if I ultimately lose?"

Mr. Smith is an average lawyer with a broad general practice who makes no pretense of specializing, least of all in the labyrinthine field of taxation. But frequently his clients ask him such questions of tax law connected with their cases. Mr. Smith feels that he should be equipped to advise upon questions which are so intimately connected with the cases he handles. Furthermore, in many instances, if so equipped, he may be able to assist his clients in making legitimate tax savings and to save his clients from "the many tax pitfalls which gape in the path these days of the general lawyer trying to practice what he thinks is non-tax law."¹⁶⁷

†In Part One, in (February 1940) 25 CORNELL L. Q. 221, the writer considered the income tax problems of plaintiffs. Parts Two and Three, herewith, deal with the problems of defendants and the general question of deducting legal expenses.

In Part One, at 231, it was stated that when a recovery is had with respect to a loss sustained in a prior year or a debt previously charged off, the recovery is taxable as income only if the deduction resulted in a tax benefit to the taxpayer. No later cases have appeared, but the Bureau of Internal Revenue has withdrawn its acquiescence in the cases there cited and has revoked its rulings to that effect. See G. C. M. 22163, (July 8, 1940) INT. REV. BULL. No. 28, p. 4. The present position of the Bureau is that, at least if a debt is actually charged off and allowed as a deduction, a subsequent recovery of the debt is taxable income even if, as a result of a net loss, no reduction of income tax resulted from the deduction. Reliance is placed upon *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 51 Sup. Ct. 150 (1931) and *Lake View Trust and Savings Bank*, 27 B. T. A. 290 (1932).

With respect to the treatment, for *excess profits tax* purposes, of income from claims and judgments which are abnormal in class or disproportionate in amount, see section 721 of the Internal Revenue Code, as added by the Second Revenue Act of 1940.

*The views expressed herein are entirely those of the writer, and nothing herein contained is to be construed as the official opinion of the Treasury Department.

¹⁶⁶"The events and characters depicted in this photoplay are fictitious. Any similarity to actual persons, living or dead, is purely coincidental."

¹⁶⁷Letter from Randolph Paul to the writer. In the preface of his *Studies in Federal Taxation* (1937), Mr. Paul said, at page iv:

The answer to his client's question lies in the application of the principle laid down by the United States Supreme Court in *North American Oil Consolidated v. Burnet*.¹⁶⁸

"If a taxpayer receives earnings *under a claim of right and without restriction as to its disposition*, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."¹⁶⁹

The two prime essentials are that there be a claim of right and no restrictions upon the disposition of the receipts. Therefore, if money is received through some mistake, which is admitted although not promptly rectified by repayment, it is not income.¹⁷⁰ Money received as agent for another is not taxable to the recipient, of course,¹⁷¹ and when the taxpayer resists an adverse claim to receipts by setting up a right in a third party, rather than

"It is now clear to many that things can no longer go on in the good old way; that a lawyer not possessing a reasonable knowledge of tax law is as incompetent as a tax man who knows nothing about non-tax law; that (to quote Professor Griswold of Harvard Law School) tax lawyers can no longer afford to 'blind themselves too much to the rest of the law'; and that, conversely, lawyers in general practice can no longer afford to shut their eyes to tax law."

¹⁶⁸286 U. S. 417, 424, 52 Sup. Ct. 613 (1932). Italics supplied.

¹⁶⁹This principle has been most unpopular with the leading writers on taxation. PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (Cum. Supp. 1939) § 11.25, note 68; MAGILL, TAXABLE INCOME (1936) 177-182 [reprinted from (1933) 46 HARV. L. REV. 933, 945-950]; Montgomery, *Accounting and the Concept of Income*, in LECTURES ON TAXATION (Columbia Univ. Symposium 1932) 55 (characterizing the rule as "taxing gross income with a vengeance").

The rationale of the rule has been variously expressed. One reason, sometimes called the "bird-in-the-hand" reason, is that the taxpayer may be insolvent and may no longer have the receipts if their taxability is postponed until the right to them is finally determined, so they are taxed when actually received. See dissent in *Alamitos Land Co.*, 40 B. T. A. 353, 364 (1939), *rev'd*, 112 F. (2d) 648 (C. C. A. 9th 1940), *cert. denied*, 61 Sup. Ct. 46 (1940). Judge Learned Hand declared, in *National City Bank v. Helvering*, 98 F. (2d) 93 (C. C. A. 2d 1938), that although taxes attach to ownership, the State should be able to collect taxes without taking sides in private controversies, and the collection of the revenue cannot be delayed until the claimants adjust their rights; hence, the taxing authorities must, as a practical matter, look to possession as *prima facie* ownership, if the possessor claims ownership and his present disposition of the fund is unrestricted. Paul and Mertens, however, contend that, once the right is determined, the Treasury should "look in the back of the book" and adjust the tax accordingly. *Loc. cit. supra*.

¹⁷⁰Carey Van Fleet, 2 B. T. A. 825 (1925) (A).

The symbol (A) after the citation of a case in the Board of Tax Appeals signifies that the Commissioner of Internal Revenue has acquiesced in an adverse ruling and that it will be followed by the Bureau. The symbol (NA) indicates non-acquiescence. Such acquiescence or non-acquiescence relates only to issues decided in favor of the taxpayer.

¹⁷¹*Comm'r v. Turney*, 82 F. (2d) 661 (C. C. A. 5th 1936); *National Railway Time Service Co. v. Comm'r*, 88 F. (2d) 904 (C. C. A. 7th 1937). *But cf.* J. R. Knowland, 29 B. T. A. 618 (1933) (money received after so long a period that claims were not likely to be made).

in himself, the receipts are not thereby rendered taxable.¹⁷² Moreover, if the taxpayer has not the unrestricted disposition of the disputed receipts, because they are held in escrow or for some other reason, the rule does not apply.¹⁷³ But where the essential elements are present, the rule is now quite firmly established that such disputed receipts are taxable.

Thus, it has been held that the income derived from property the title to which is in dispute, as well as the gain from the sale of such property, is taxable.¹⁷⁴ The profits of a patent infringer are taxable although he is later

¹⁷²*Comm'r v. Brown*, 54 F. (2d) 563 (C. C. A. 1st 1931), *cert. denied*, 286 U. S. 556, 52 Sup. Ct. 639 (1932) (by regulations of War Industries Board, taxpayer's profits as a licensed wool dealer were limited to 5%, the excess to be disposed of as the Government might decide; when distribution was ordered, taxpayer refused to comply, on the ground that the plan was not fair to the growers, but he made no claim on his own behalf; held, not taxable).

¹⁷³*Sara R. Preston*, 35 B. T. A. 312 (1937) (A). But *cf. infra* note 200. With respect to receipts impounded under court order, see *infra* part 2 (c).

The fact that the taxpayer voluntarily sets up a separate account and indicates on his books an intention not to exercise his absolute dominion over the fund until the right is determined does not alone prevent its taxability as income. *Comm'r v. Alamitos Land Co.*, 112 F. (2d) 648 (C. C. A. 9th 1940), *cert. denied*, 61 Sup. Ct. 46 (1940).

In the absence of a dispute over the right to the receipts, escrow alone may not be sufficient to prevent taxability. See 1 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) §§ 10.15, 11.26, and 11.27.

¹⁷⁴*North American Oil Consolidated v. Burnet*, 286 U. S. 417, 52 Sup. Ct. 613 (1932); *J. H. Tippet*, 25 B. T. A. 69 (1932); *McDuffie v. United States*, 19 F. Supp. 239, 85 Ct. Cl. 212 (1937) (all relating to current income from disputed property); *Arthur A. Cocke*, 5 B. T. A. 606 (1926) (gain from sale of disputed property). The Treasury originally took a contrary position, in O. D. 1141, 5 CUM. BULL. 134 (1921), and G. C. M. 1582, VI-1 CUM. BULL. 171 (1927), but those rulings were modified in conformity with the above cases, in G. C. M. 16730, XV-1 CUM. BULL. 179 (1936) and I. T. 2983, XV-1 CUM. BULL. 299 (1936).

Cf. Ford v. Comm'r, 51 F. (2d) 206 (C. C. A. 6th 1931), *cert. denied*, 284 U. S. 666, 52 Sup. Ct. 41 (1931), with *Ford v. Nauts*, 25 F. (2d) 1015 (N. D. Ohio 1928), reaching conflicting results upon the same facts, with respect to the income from securities prematurely distributed from an estate and subsequently returned under a consent decree. The circuit court of appeals decision, although not a direct reversal of the district court case, is in accord with the principle subsequently announced by the Supreme Court.

An early ruling held that when an investor in a "blind pool" receives what are supposed to be profits of the pool, when in fact there are no profits, he may get a refund of the tax paid thereon when he is subsequently required to restore the "profits" at the suit of the pool operator's trustee in bankruptcy. I. T. 2326, V-2 CUM. BULL. 147 (1926). *Quaere*, whether the "claim of right" principle would now be applied in favor of the taxability of receipts subsequently adjudged to be fraudulent conveyances or illegal preferences.

When the income of disputed property of an exhaustible nature is taxed under this principle, it has been held that an allowance for depletion or depreciation is made in the usual manner, even though a subsequent decree may establish that the taxpayer had no interest in the property; the theory of the cases is that the fact that he is taxed upon income he cannot keep does not require that he also be taxed upon capital he cannot keep. *Champlin v. Comm'r*, 78 F. (2d) 905 (C. C. A. 10th 1935); *Obispo Oil Co. v. Welch*, 85 F. (2d) 860 (C. C. A. 9th 1936), *rev'd on jurisdictional grounds*, 301 U. S. 190, 57 Sup. Ct. 684 (1937); L. O. 1110, II-1 CUM. BULL. 104 (1923) (probably no longer in force in view of the position taken by the Bureau in the cases cited). But see dissent of Judge Wilbur in the *Obispo* case, *supra*, at 863.

The abbreviation "CUM. BULL." stands for the Cumulative Bulletin (Internal Revenue rulings).

compelled to account for them.¹⁷⁵ Improper compensation and secret profits of corporate directors, partners, and other fiduciaries are subject to tax,¹⁷⁶ as are the proceeds of embezzlement.¹⁷⁷ Dividends which may be recovered back because unlawfully paid are nevertheless taxable income,¹⁷⁸ and the same is true of receipts pursuant to a contract which the other party is seeking to rescind or to have construed in such a way that the income may later have to be given up.¹⁷⁹ The gain realized by a vendor from the resale of property obtained by the foreclosure of a land contract may not be held in abeyance pending litigation over the vendor's right to retain it.¹⁸⁰ Receipts from illegal gambling,¹⁸¹ usury,¹⁸² or short-changing of customers,¹⁸³ although recoverable from the taxpayer, are nevertheless taxable income.

The authorities are not in agreement, however, with respect to the effect of an actual repayment of the money. It is generally agreed that disputed

¹⁷⁵O. D. 1141, 5 CUM. BULL. 134 (1921).

¹⁷⁶*Board v. Comm'r*, 51 F. (2d) 73 (C. C. A. 6th 1931), *cert. denied*, 284 U. S. 658, 52 Sup. Ct. 35 (1931) (director's profit on contract with corporation, contested by stockholders); *National City Bank v. Helvering*, 98 F. (2d) 93 (C. C. A. 2d 1938) (director held out part of profits on illegal oil lease, repaid to corporation during Senate investigation); *Griffin v. Smith*, 101 F. (2d) 348 (C. C. A. 7th 1939), *cert. denied*, 60 Sup. Ct. 73 (1939) (corporate officer and director paid self excessive bonuses, refunded on demand of stockholders); *Saunders v. Comm'r*, 101 F. (2d) 407 (C. C. A. 10th 1939), *aff'g* *Lewis v. United States*, 17 F. Supp. 543 (D. Colo. 1936) (officer's commission on sale of stock, restored on demand); *United States v. Wampler*, 5 F. Supp. 796 (D. Md. 1934) (attorney misapplied client's funds); *Penn v. Robertson*, 29 F. Supp. 386 (M. D. N. C. 1939) (corporate officer given right to purchase stock far below market, saving held income although subsequently given up); *D. H. Byrd*, 32 B. T. A. 568 (1935) (joint adventurer bought on his own account, later held accountable for profits); *G. C. M. 16730*, XV-1 CUM. BULL. 179 (1936) (secret profits of director). An early case to the contrary is *Walter Cravens*, 3 B. T. A. 282 (1926) (corporate officer paid self commissions, amount disputed, repaid in later year; held, not income).

¹⁷⁷*G. C. M. 16572*, XV-1 CUM. BULL. 82 (1936). *See contra*: *Rau v. United States*, 260 Fed. 131, 136 (C. C. A. 2d 1919), which was expressly overruled on this point in *National City Bank v. Helvering*, 98 F. (2d) 93, 96 (C. C. A. 2d 1938).

¹⁷⁸*Angelus Bldg. & Inv. Co. v. Comm'r*, 57 F. (2d) 130 (C. C. A. 9th 1932), *cert. denied*, 286 U. S. 562, 52 Sup. Ct. 644 (1932).

¹⁷⁹*Griffin v. Smith*, 101 F. (2d) 348 (C. C. A. 7th 1939), *cert. denied*, 308 U. S. 561, 60 Sup. Ct. 73 (1939); *Earl M. Palmer*, 3 B. T. A. 403 (1926) (A); *Hans Pederson*, 14 B. T. A. 1089 (1929) (NA), *appeal dismissed*, 48 F. (2d) 1080 (C. C. A. 9th 1931); *Arabol Mfg. Co.*, 26 B. T. A. 1068 (1932) (NA).

Under the completed contract method of accounting, the income therefrom is reported when the contract is completed and payment made, and the profit cannot be held in suspense pending settlement of all claims and contingent liabilities growing out of the contract. *Grays Harbor Motorship Corp. v. United States*, 45 F. (2d) 259, 280, 71 Ct. Cl. 167, 211, *cert. denied*, 284 U. S. 627, 52 Sup. Ct. 11 (1931). *But cf.* *Carolina Contracting Co.*, 32 B. T. A. 1171 (1935) (A).

¹⁸⁰*R. A. Rowan & Co.*, 13 B. T. A. 975 (1928).

¹⁸¹*James P. McKenna*, 1 B. T. A. 326 (1925).

¹⁸²*W. R. Hervev*, 25 B. T. A. 1282 (1932). *See* *Barker v. Magruder*, 95 F. (2d) 122, 123, 68 App. D. C. 211 (1938).

¹⁸³*Chicago. R. I. & P. Ry. v. Comm'r*, 47 F. (2d) 990 (C. C. A. 7th 1931), *cert. denied*, 284 U. S. 618, 52 Sup. Ct. 7 (1931) (no claim of right, but extremely remote possibility that unknown losers would seek or get refund).

receipts are income which must be reported when received, but some cases have held that the return in which the income was reported is subject to correction and refund of tax when the receipts are taken away in a subsequent year; the usual theory of that line of cases is that the receipts were subject to a constructive trust and the taxpayer, therefore, never acquired title to them.¹⁸⁴ The Fifth Circuit went further and held that, even in the absence of repayment, if the taxpayer's claim of right is wholly unfounded under well-settled principles of law, the receipts are not taxable.¹⁸⁵ But the great bulk of the more recent cases have followed the "claim of right" doctrine to its logical extreme—as in fact they were justified in doing by a dictum in the *North American Oil* case itself¹⁸⁶—and have held that the repayment of the money in a later year, whether by compromise or by judgment, does not affect the taxability of the receipts;¹⁸⁷ the repayment must be treated

¹⁸⁴*Ford v. Nauts*, 25 F. (2d) 1015 (N. D. Ohio 1928) [a case which has been virtually repudiated in the circuit of its origin, on the same facts, in connection with a later year's return. *Ford v. Comm'r*, 51 F. (2d) 206 (C. C. A. 6th 1931), *cert. denied*, 284 U. S. 666, 52 Sup. Ct. 41 (1931)]; *Jesse E. La Dow*, 3 B. T. A. 219 (1925) (court had held taxpayer constructive trustee of stock); *Walter Cravens*, 3 B. T. A. 282 (1926) (A); *O. B. Barker*, 3 B. T. A. 1180 (1926) (A) (stockholder received liquidating dividend, later held liable for corporate tax deficiency; held that his dividend was impressed with a trust and was never income, to the extent of the tax liability subsequently determined); *Great Southern Life Ins. Co.*, 33 B. T. A. 512, 522 (1935), *aff'd on other grounds*, 89 F. (2d) 54 (C. C. A. 5th 1937), *cert. denied*, 302 U. S. 698, 58 Sup. Ct. 16 (1937). The Treasury at one time accepted this theory. O. D. 1141, 5 CUM. BULL. 134 (1921); G. C. M. 1582, VI-1 CUM. BULL. 171 (1927); *see also* I. T. 2326, V-2 CUM. BULL. 147 (1926). But it was repudiated in G. C. M. 16730, XV-1 CUM. BULL. 179 (1936).

In *Lewis v. United States*, 17 F. Supp. 543 (D. Colo. 1936), the court declared that the "constructive trust" theory was never applied unless the judgment of a court had decreed that such a trust existed, or evidence was presented to the Board or the tax court from which it could make such a finding; that a mere compromise did not *per se* establish that the taxpayer had not had actual title between the time of receipt and the settlement. In affirming, the circuit court declared, by way of dictum, that even a judicial decree of liability to return the receipts would not render the original receipt not taxable. *Saunders v. Comm'r*, 101 F. (2d) 407 (C. C. A. 10th 1939).

¹⁸⁵*Comm'r v. Turney*, 82 F. (2d) 661 (C. C. A. 5th 1936). Judge Hutcheson dissented, declaring that, no matter how unfounded the claim, the material factor is the *intent* with which the money is received; it is a *recognized* obligation to account, not a *well-founded* obligation, that renders it non-taxable. The *Turney* case was expressly disapproved by Judge Learned Hand in *National City Bank v. Helvering*, 98 F. (2d) 93, 96 (C. C. A. 2d 1938).

The theory underlying the *Turney* case is supported also by Magill, *When Is Income Realized?* (1933) 46 HARV. L. REV. 933, 945-950, arguing that the apparent validity of the taxpayer's claim of right should be controlling, as bearing upon the likelihood of his ultimately keeping the gains.

¹⁸⁶286 U. S. 417, 424, 52 Sup. Ct. 613 (1932). The Supreme Court declared, citing *Lucas v. American Code Co.*, 280 U. S. 445, 50 Sup. Ct. 202 (1930), that if the income were later given up, it would have to be deducted in the later year and not excluded from the gross income of the year of receipt.

¹⁸⁷*Ford v. Comm'r*, 51 F. (2d) 206 (C. C. A. 6th 1931), *cert. denied*, 284 U. S. 666, 52 Sup. Ct. 41 (1931) (returned under consent decree); *National City Bank v. Helvering*, 98 F. (2d) 93 (C. C. A. 2d 1938) (returned voluntarily under pressure of Senate in-

as a loss in the year in which it is made.¹⁸⁸

The Supreme Court, in *Freuler v. Helvering*,¹⁸⁹ refused to extend the "claim of right" rule to cover income from a trust. Under Section 162(b) of the Internal Revenue Code, the trustee may deduct and the beneficiary is taxed upon income which "is to be distributed currently," whether distributed or not.¹⁹⁰ The Supreme Court held that when income was improperly distributed to a life beneficiary, which a later court decree determined had to be returned to the trust, the income tax was not currently "distributable" in the first place, and was not taxable even though the beneficiary had received it under a claim of right. The necessary corollary to this rule is that no deduction may be taken when a court orders its restoration, nor may sums be excluded from the beneficiary's taxable income which the trustee retains to make up the deficiency.¹⁹¹

vestigation); *Griffin v. Smith*, 101 F. (2d) 348 (C. C. A. 7th 1939), *cert. denied*, 60 Sup. Ct. 73 (1939) (returned in compromise); *Saunders v. Comm'r*, 101 F. (2d) 407 (C. C. A. 10th 1939), *aff'g* *Lewis v. United States*, 17 F. Supp. 543 (D. Colo. 1936) (compromise); *Comm'r v. Alamitos Land Co.*, 112 F. (2d) 648 (C. C. A. 9th 1940), *cert. denied*, 61 Sup. Ct. 46 (1940) (judgment collected, repaid after reversal); *McDuffie v. United States*, 19 F. Supp. 239, 85 Ct. Cl. 212 (1937) (judgment compelled return; court rejects constructive trust theory); *Penn v. Robertson*, 29 F. Supp. 386 (M. D. N. C. 1939) (compromise); *W. R. Hervey*, 25 B. T. A. 1282 (1932) (A) (compromise); *Arabol Mfg. Co.*, 26 B. T. A. 1068 (1932) (NA) (compromise); *D. H. Byrd*, 32 B. T. A. 568 (1935) (judgment); *G. C. M.* 16730, XV-1 Cum. BULL. 179 (1936) (judgment). Cf. *J. H. Tippet*, 25 B. T. A. 69 (1932) (adverse judgment, pending on appeal and unpaid).

¹⁸⁸*Penn v. Robertson*, 29 F. Supp. 386 (M. D. N. C. 1939) (an extreme case, permitting deduction of the repayment even though the original receipt had not been reported and the statute of limitations had passed, since it was properly taxable at that time); *W. R. Hervey*, 25 B. T. A. 1282 (1932) (A); see *North American Oil Consolidated v. Burnet*, 286 U. S. 417, 424, 52 Sup. Ct. 613 (1932). A contrary result is required under the constructive trust theory, since the taxpayer loses nothing he ever owned. *Jesse E. La Dow*, 3 B. T. A. 219 (1925).

Of course, under this procedure, the transaction must be connected with the taxpayer's business or a transaction entered for profit; otherwise the repayment is not deductible as a loss even though the contested receipt was taxed. See *infra* Part 2 (d). Furthermore, he may have no income against which to offset the loss in the later year.

¹⁸⁹291 U. S. 35, 54 Sup. Ct. 308 (1934).

¹⁹⁰This section has undergone several verbal changes, but the interpretation with respect to propositions corollary to that of the *Freuler* case has been uniform (see note 126c, Part One). Section 2 (b) of the Revenue Act of 1916 provided that the entire income was taxed to the trustee but the rate was made dependent upon the individual shares, "so far as the income is to be distributed annually." Section 219 (d) of the Act of 1918 taxed to the beneficiaries their "distributive share." Section 219 (d) of the Act of 1921 taxed to the beneficiary the income "which pursuant to the instrument or order governing the distribution is distributable." All subsequent acts have allowed the trustee a deduction for income which "is to be distributed currently", and taxed to the beneficiary "the amount so allowed as a deduction."

The *Freuler* case arose under the 1921 Act, but, as indicated above, the cases have construed the later acts as making no change in this respect. See, e.g., *Hubbell v. Helvering*, 70 F. (2d) 668 (C. C. A. 8th 1934); *De Brabant v. Comm'r*, 90 F. (2d) 433 (C. C. A. 2d 1937); *Lawrence Fox et al.*, Exec'rs, 31 B. T. A. 1181 (1935); *Marguerite Hyde Suffolk & Berks*, 40 B. T. A. 1120 (1939) (A).

¹⁹¹*Mary V. Pyle*, 16 B. T. A. 218 (1929) (1921 Act); *Marguerite Hyde Suffolk & Berks*, 40 B. T. A. 1120 (1939) (A) (1932 and 1934 Acts).

b. *Valuation of disputed titles*

In many instances, Mr. Smith's client will not be interested in the valuation, for income tax purposes, of his disputed title. For the actual cost of the property, adjusted in accordance with the statute, will usually afford the basis for depletion or depreciation, and adjusted cost and selling price normally determine the gain or loss if he disposes of it. However, in connection with property transmitted at death, acquired by gift or taxable exchange, or owned prior to March 1, 1913, the fair market value of the property is, in certain circumstances, used as a basis for the purposes mentioned.¹⁹² It has been held that when property the title to which is in dispute is acquired through an exchange (which would ordinarily be taxable), if the title hazard is such that the property could not be sold except at a great sacrifice, it has no fair market value and no gain or loss is recognized; the property acquired takes the basis of the old property, with proper adjustments, and the determination of gain or loss is postponed until the new property is disposed of.¹⁹³ However, for purposes of determining depreciation, depletion, or the gain or loss upon the disposition of property which was acquired by inheritance or gift, or which was owned prior to March 1, 1913, it is impossible so to postpone determination of the value.¹⁹⁴ It has been held, therefore, that, if the title was in dispute at the time to which the value must be related, the valuation must nevertheless be based upon the value of the good title which the taxpayer was later found to have, rather than of the disputed title which he acquired.¹⁹⁵

¹⁹²See Internal Revenue Code § 113 (a).

For property acquired by gift after December 31, 1920, the basis for gain is the donor's basis; for loss, it is the donor's basis or the *fair market value* at date of gift, whichever is lower. [§ 113 (a) (2)]. For property acquired by gift before January 1, 1921, or property transmitted at death (at any time), the basis is the *fair market value* at date of acquisition. [§ 113 (a) (4) (5)]. For property acquired before March 1, 1913, the basis for gain is the cost or March 1, 1913, *value*, whichever is greater; for loss, it is cost. [§ 113 (a) (14)]. When property is acquired in a taxable exchange, the selling price of the old and the cost basis of the new property are the *fair market value* of the new property. [§ 111 (b)].

See discussion in 5 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 52.01.

¹⁹³*Champlin v. Comm'r*, 71 F. (2d) 23, 28 (C. C. A. 10th 1934). Cf. *Helvering v. Tex-Penn Co.*, 300 U. S. 481, 499, 57 Sup. Ct. 569 (1937). The cases were decided under section 202 (b) of the Revenue Act of 1918, which used the language, "fair market value, *if any*." Section 111 (b) of the present Code lacks the words, "if any." However, it is still recognized by the regulations that, "in rare and extraordinary cases," property received in an exchange may have no fair market value, presumably with the effect indicated in the text. Regulations 103, sec. 19.111-1.

¹⁹⁴Cf. *Burnet v. Logan*, 283 U. S. 404, 412, 51 Sup. Ct. 550 (1931).

¹⁹⁵*Heiner v. Hewes*, 30 F. (2d) 787 (C. C. A. 3d 1929). The case seems inconsistent in principle with the later Supreme Court case of *United States v. Safety Car Heating Co.*, 297 U. S. 88, 56 Sup. Ct. 353 (1936), which held that a mere cause of action had no value prior to its final determination; but the Supreme Court expressly

c. *Impounded income*

Shortly after the client brought his case to Attorney Smith, the plaintiff procured the appointment of a receiver.

"Mr. Smith," asked the client, "I no longer can enjoy the income of my property, and in fact I may never enjoy it. Must I pay an income tax on it?"

The categorical answer to that question is that he need not, but the question of *who* must pay the tax and at what time depends upon the nature of the receivership.

Section 52 of the Internal Revenue Code requires that a receiver operating the property of a corporation shall stand in the place of the corporation and pay its income tax.¹⁹⁶ It has been held, however, that that section relates only to a receiver operating the *entire* property or business of a corporation, and the receiver of a *part* of the property of a corporation is not taxable.¹⁹⁷

Similarly, the receiver of all of the property of an individual stands in his stead and must pay tax as a fiduciary;¹⁹⁸ but the receiver of part of the property of an individual is expressly exempted from the statutory provision respecting fiduciary returns, and is held not to be subject to tax.¹⁹⁹

The non-taxability of receivers of part of the property of individuals or corporations most clearly extends to such receivers as those appointed in mortgage foreclosures and partition proceedings, where the equitable ownership of the property and its income is not in dispute.²⁰⁰ The Supreme Court, furthermore, has held that the receiver appointed pending litigation over the right to property likewise was not taxable.²⁰¹ A more recent case in the

distinguished and preserved the case of *Heiner v. Hewes* (297 U. S. at 98). Cf. *Security-First National Bank of Los Angeles, Exec'r*, 35 B. T. A. 815, 823 (1937) (for estate tax purposes, a disputed claim for a tax refund was valued at face value, which was subsequently recovered).

Early cases in the Board took a contrary view. *Charles P. Hewes*, 2 B. T. A. 1279 (1925); *Gilbert Butler*, 4 B. T. A. 756 (1926).

With respect to determining the period for which disputed property has been held, for purposes of the capital gain and loss provisions, see *R. S. Goforth*, 32 B. T. A. 1206, 1214 (1935) (NA), *appeals dismissed*, 84 F. (2d) 1003 and 86 F. (2d) 1000 (C. C. A. 10th 1936) (dictum that time of acquisition was not when title litigation was settled by large payment from taxpayer).

¹⁹⁶*United States v. Chicago & E. I. Ry.*, 298 Fed. 779 (N. D. Ill. 1924); Regulations 103, secs. 19.52-2 and 19.142-4.

In such a case, of course, no second tax is payable by the corporation when the income is released. Cf. *Comm'r v. Owens*, 78 F. (2d) 768, 776 (C. C. A. 10th 1935).

¹⁹⁷*North American Oil Consolidated v. Burnet*, 286 U. S. 417, 52 Sup. Ct. 613 (1932); Regulations 103, secs. 19.52-2 and 19.142-4.

¹⁹⁸Regulations 103, sec. 19.142-4.

¹⁹⁹Internal Revenue Code § 142 (a); *Benton Wilson*, 33 B. T. A. 649 (1935) (discussing the history of this provision).

²⁰⁰Regulations 103, secs. 19.52-2 and 19.142-4.

²⁰¹*North American Oil Consolidated v. Burnet*, 286 U. S. 417, 52 Sup. Ct. 613 (1932), involving a dispute over property held by a corporation; the predecessor of section 52

Tenth Circuit, however, casts substantial doubt upon whether that position is correct.²⁰² That case held *taxable* receivers in *heirship* disputes and other cases where a title contest is not between definitely ascertained persons (involving, for example, the validity, priority, or construction of a conveyance) but is among an indefinite number of unascertained persons claiming to occupy a particular *status*. It was held that such a receiver is taxable as a trustee for an unascertained person,²⁰³ and that he is not exempted under the exception for a receiver of part of the property of an individual²⁰⁴ because it is impossible at the time to know whether he holds all or part of any individual's property. Although the Supreme Court's rule respecting title disputes between "ascertained" persons was distinguished, the distinction seems specious, for the "potential taxpayer" is no more and no less known in the ordinary suit concerning a defect in title than in the heirship dispute, although the group in which he is to be found may be more clearly defined.

It seems, therefore, that either the Supreme Court's view or that of the Tenth Circuit is in error, and that one position or the other should be followed to its logical conclusion. On the one hand, it is arguable that no receivers are taxable unless they completely stand in the place of the owner, and that the exception for receivers of part of one's property extends to all other receivers, with the purpose of eliminating two partial returns for the same person. On the other hand, the position seems equally supportable (if the Supreme Court case can be disposed of)²⁰⁵ that the exception is con-

of the Code, requiring returns of receivers operating the property of a corporation, was held to be confined to receivers of the entire property. The same rule was applied to a receiver in a dispute over the title to an individual's property in *Benton Wilson*, 33 B. T. A. 649 (1935). *Contra*: *Ida Wolf Schick*, 22 B. T. A. 1067 (1931).

But one holding impounded property other than in the capacity of a receiver is taxed as a fiduciary under section 161 of the Code. *Ferguson v. Forstmann*, 25 F. (2d) 47 (C. C. A. 3d 1928) (corporation, by court order, held up duly declared dividend until right to it was determined); *Hart v. Comm'r*, 54 F. (2d) 848 (C. C. A. 1st 1932) (bonds deposited with plaintiff by defendant to stay execution pending appeal; interest held taxable to plaintiff as fiduciary); *Buckley v. Comm'r*, 66 F. (2d) 394 (C. C. A. 2d 1933) (court placed condemnation award in hands of city chamberlain to be held for benefit of whoever should become entitled to contingent remainder upon death of life tenant; income of fund held taxable to custodian, expressly upon the ground that he was not shown to be a "receiver" within the statutory exception).

²⁰²*Comm'r v. Owens*, 78 F. (2d) 768 (C. C. A. 10th 1935), *aff'g* 26 B. T. A. 1147 (1932). *Cf.* *R. S. Goforth*, 32 B. T. A. 1206 (1935) (NA), *appeals dismissed*, 84 F. (2d) 1003 and 86 F. (2d) 1000 (C. C. A. 10th 1936) (no receivership, but *lessees* impounded royalties pending heirship dispute).

²⁰³Internal Revenue Code § 161.

²⁰⁴Internal Revenue Code § 142.

²⁰⁵The *North American Oil* case, *supra* note 197, upon which the other cases relied, failed to consider the predecessor of section 161, but held only that the predecessor of section 52 was inapplicable. Therefore, if properly raised, it could still be held that the receiver in such a case is a separate taxable entity as a fiduciary holding for an unascertained person. *Cf. Helvering v. Wood*, 309 U. S. 344, 348, 60 Sup. Ct. 551, 553 (1940).

fined to cases where the equitable ownership is known, and that receivers in title disputes of all varieties are taxable as fiduciaries.

In cases where the receiver is taxable, the ultimate distributee of the income is not taxable upon it, since the law does not contemplate taxing the same income twice.²⁰⁶ But when receivers are not taxable, there must be some provision for taxing the income to its *owner*. Since he does not have the unrestricted enjoyment of the income, and since he may never receive it, the "claim of right" principle does not apply, and the income is too contingent to accrue prior to its release by the receiver.²⁰⁷ Therefore, at the time the receivership is terminated, the prevailing party pays tax upon the accumulated income which is released to him.²⁰⁸ Under the "claim of right" rule, however, if the defendant gives bond and obtains the enjoyment of the income, he becomes taxable upon it at that time even though he may subsequently lose it.²⁰⁹ It has been held, furthermore, that if it is legally possible to end the receivership and withdraw the income by giving a bond, so that the taxpayer can obtain the income at his own option, the income is taxable as if he had done so;²¹⁰ this result seems questionable, however, for the right to withdraw the income is far from unconditional when a bond must be given, which frequently necessitates the furnishing of security.²¹¹

d. *Adverse judgments: if deductible*

When a defendant loses in an action or makes a settlement thereof, is the amount of his loss deductible from his taxable income?²¹² Not every expendi-

²⁰⁶Comm'r v. Owens, 78 F. (2d) 768, 776 (C. C. A. 10th 1935).

²⁰⁷Income impounded by a receiver in a mortgage foreclosure or similar action, where the defendant's equitable interest is *undisputed* and the income is to be applied upon his debt, may well be taxable to the defendant without postponement, at least on the accrual basis.

²⁰⁸North American Oil Consolidated v. Burnet, 286 U. S. 417, 52 Sup. Ct. 613 (1932); Umsted v. Comm'r, 72 F. (2d) 328 (C. C. A. 8th 1934) (oil lands descended to taxpayer while in hands of receiver; held that accumulated income, when released to him, was taxable income and not corpus of the estate); Comm'r v. Owens, 78 F. (2d) 768, 776 (C. C. A. 10th 1935); Trojan Oil Co., 26 B. T. A. 659 (1932) (NA); Nat'l Petroleum & Refining Co., 28 B. T. A. 569 (1933); Benton Wilson, 33 B. T. A. 649 (1935).

But cf. Obispo Oil Co. v. Welch, 48 F. (2d) 872 (S. D. Cal. 1931), *rev'd on other grounds*, 85 F. (2d) 860 (C. C. A. 9th 1936), *rev'd on jurisdictional grounds*, 301 U. S. 190, 57 Sup. Ct. 684 (1937) (district court held *corporation* taxable during receivership; undoubtedly overruled by the Supreme Court in the *North American Oil* case).

²⁰⁹Comm'r v. Brooklyn Union Gas Co., 62 F. (2d) 505 (C. C. A. 2d 1933).

²¹⁰*Ibid.*

²¹¹See dissent of Judge Learned Hand, *id.* at 507. Even when the taxpayer actually gives bond and receives the income, it is hard to see that income is realized, for the bond stands as a substitute for the withdrawn income and the situation is much the same as if the income were escrowed.

²¹²At least if the settlement is *bona fide*, the right to deduct is not affected by the fact that, by fighting the case, the defendant might have been held not liable. Humphrey v. Comm'r, 91 F. (2d) 155 (C. C. A. 9th 1937); Olympia Harbor Lumber Co., 30 B. T. A. 114 (1934) (A), *aff'd on other grounds*, 79 F. (2d) 394 (C. C. A. 9th 1935). *Cf.*

ture made by a taxpayer may be deducted, but only such as are expressly provided for in the Internal Revenue Code.²¹³ The statute permits the deduction of "all the ordinary and necessary expenses paid or incurred . . . in carrying on a trade or business";²¹⁴ of all uncompensated losses sustained by a corporation;²¹⁵ and of uncompensated losses sustained by individuals "if incurred in trade or business," or "if incurred in any other transaction entered into for profit, though not connected with trade or business," or losses "of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck or other casualty, or from theft."²¹⁶ With a few exceptions, which will be discussed in due course,²¹⁷ no judgments may be deducted unless they fit one of those provisions. Expressly denied are deductions of personal expenses²¹⁸ and capital expenditures.²¹⁹

Therefore, one may deduct judgments and settlements resulting from the operations of a trade or business, as business expenses,²²⁰ except where pub-

Gwathmey v. Comm'r, 76 F. (2d) 754 (C. C. A. 2d 1935) (settled suit for accounting of funds entrusted to taxpayer; he claimed that suit was unfounded and he made settlement only to avoid long and expensive litigation; if suit *was* well-founded, no loss was suffered, for taxpayer gave up only what rightfully belonged to plaintiff; deduction denied for lack of proof that suit was groundless).

The reimbursement, pursuant to contract, of one conducting a test case in which the taxpayer is interested appears to stand upon the same footing as a judgment or settlement. Findley v. United States, 28 F. Supp. 715 (W. D. La. 1939).

²¹³"Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." New Colonial Ice Co. v. Helvering, 292 U. S. 435, 440, 54 Sup. Ct. 788 (1934).

²¹⁴Internal Revenue Code § 23 (a) (1). On the meaning of "ordinary and necessary," see 3 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 23.38.

²¹⁵Internal Revenue Code § 23 (f). Note that the restrictions placed upon the deductibility of individual losses, *infra*, do not apply to corporate losses. However, corporate losses are presumably incurred in business; and it has been held that the statute contemplates only losses in "normal business transactions". Pennsylvania Indemnity Co., 30 B. T. A. 413, 415 (1934), *aff'd*, 77 F. (2d) 92 (C. C. A. 3d 1935), *cert. denied*, 296 U. S. 588, 56 Sup. Ct. 99 (1935).

²¹⁶Internal Revenue Code § 23 (e).

Although the damage to *property* suffered in an automobile accident, not connected with one's business, gives rise to a *casualty* deduction [Shearer v. Anderson, 16 F. (2d) 995 (C. C. A. 2d 1927); W. S. Bronson, 9 B. T. A. 1008 (1927) (A); Regulations 103, sec. 19.23 (e)-1], a *judgment* or settlement for damages to person or property suffered by the *other* party is not a loss of *property* from casualty and is not deductible as such, although it may be a *business* loss. Fred J. Hughes, 1 B. T. A. 944 (1925); L. Oransky, 1 B. T. A. 1239 (1925); B. M. Peyton, 10 B. T. A. 1129 (1928). The casualty provision is, therefore, of no avail to unsuccessful defendants.

²¹⁷By virtue of the provisions for the deduction of interest [§ 23 (b)], taxes [§ 23 (c)], and bad debts [§ 23 (k)], none of which are restricted to business transactions, certain judgments or parts thereof may result in deductions. See *infra*, notes 257, 262, and 291.

²¹⁸Internal Revenue Code § 24 (a) (1).

²¹⁹Regulations 103, sec. 19.24-2.

²²⁰The problem of defining the term "business" is beyond the scope of this article, except so far as considered *infra* notes 364, 369-372.

The fact that one is no longer engaged in the business at the time the judgment is awarded or the settlement is made is immaterial if the liability is proximately connected with the business. I. T. 1789, II-2 CUM. BULL. 121 (1923). Cf. I. T. 3325, 1939-2 CUM. BULL. 151 (involving attorney's fees):

lic policy forbids the deduction.²²¹ It appears, too, that a liability not falling within the definition of a business expense may nevertheless be deducted as a *loss* if it meets the above requirements for deductibility of losses.²²² On the other hand, deduction may be denied even for a business liability if it is connected with the acquisition of property or the protection of title to property, such capital expenditures being added to the cost for purposes of computing depreciation, depletion, or the gain or loss upon the disposition of the property.²²³

The illustrative cases are so numerous and varied that they can best be considered in categories representing the major fields of the law.

Contracts: Liabilities for breach of contracts made in the ordinary course of trade or business are deductible.²²⁴ Liabilities incurred in connection with

²²¹See *Crimes, infra*. Cf. *Torts, infra*.

²²²The distinction between losses and expenses has never been clearly defined and the terms are frequently used indiscriminately or alternatively in the cases, but the distinction is important because the deduction of losses is much less restricted. It would seem that no true "loss" is sustained unless some asset has been acquired and lost, and that other expenditures must meet the requirements for a business expense deduction. See *Pacific Coast Biscuit Co.*, 32 B. T. A. 39, 42 (1935); 3 PAUL & MERTENS, *LAW OF FEDERAL INCOME TAXATION* (1934) §§ 26.29 and 26.35. In 3 *id.* § 23.49, damages are treated as *expenses*. Although the word "loss" is frequently used in connection with judgments, properly they should be treated as expenses since they are not related to any asset. However, those liabilities and payments which are denied current deduction as *capital* expenditures may become part of the cost and hence be reflected in an increased *loss* or decreased gain at a later date. Nevertheless, there are a few cases which have squarely held that an expenditure which fails to result in the acquisition of an asset is deductible under the *loss* provisions. *Seufert Bros. Co. v. Lucas*, 44 F. (2d) 528 (C. C. A. 9th 1930); *North American Investment Co.*, 24 B. T. A. 419 (1931) (NA) (corporation's payment to cancel fraudulently issued stock; held, a loss, since nothing of recognized value was acquired); *Portland Furniture Mfg. Co.*, 30 B. T. A. 878 (1934) (NA) (legal expenses in merger which was abandoned). And at least one case, in which the Bureau acquiesced, allowed as a *loss* a *judgment* arising out of a non-business transaction entered for profit. *W. R. Hervey*, 25 B. T. A. 1282 (1932) (A). Cf. *Marjorie Fleming Lloyd-Smith*, 40 B. T. A. 214, 222 (1939).

²²³The effects of holding an expenditure to be a capital expenditure are several. Although no current deduction is permitted, the expenditure ordinarily becomes part of the cost of the property in connection with which it is incurred, resulting in an increased loss or diminished gain when it is disposed of, and greater depreciation or depletion meanwhile. If it results in an increased *loss*, the benefit thereof may be had even though it is not connected with business, if it is connected with a transaction entered for profit, which would not be permissible if it were a current expense. If it decreases a *gain*, the benefit thereof may be had in all cases, since gains upon the disposition of *any* property are taxed. On the other hand, whatever the nature of the transaction, if the property is within the definition of a "capital asset", the benefits will be restricted by the limitations in section 117 of the Internal Revenue Code.

²²⁴*Producers Fuel Co.*, 1 B. T. A. 202 (1924) (A); *Raleigh Smokeless Fuel Co.*, 6 B. T. A. 381 (1927) (A); *Frank L. Orth*, 9 B. T. A. 249 (1927) (A); *Fraser Brick Co.*, 10 B. T. A. 1252 (1928) (A); *Thorne, Neal & Co.*, 13 B. T. A. 490 (1928) (NA); *Trippensee Mfg. Co.*, 15 B. T. A. 15 (1929) (NA); *Olympia Harbor Lumber Co.*, 30 B. T. A. 114 (1934) (A), *aff'd on other grounds*, 79 F. (2d) 394 (C. C. A. 9th 1935).

Respecting the liability of an employer for dismissing an employee in violation of contract, cf. *infra* note 234.

In all of the cases cited, the deduction was allowed as an ordinary and necessary

one's employment are likewise deductible.²²⁵ On the other hand, of course, contract obligations for which money or property (other than inventories) was received are not deductible.

*Corporations and Partnerships.*²²⁶ When a corporation, by vote of its dominant stockholders, makes a payment to a minority stockholder in settlement of his threatened suit demanding preemptive rights in new stock, it is a mere distribution of assets and not a deductible loss or expense.²²⁷ Similarly, when the corporation, to put an end to obstructionist tactics and vexatious litigation by minority stockholders, makes a settlement with them as a result of which their stock is surrendered, the transaction is viewed as a purchase and no deduction results.²²⁸ But when an officer of a corporation fraudulently issues its stock without consideration, and to avoid litigation the corporation makes a partial payment to cancel the void stock, it has been held that it acquires nothing of value and the payment is a deductible loss.²²⁹ Conversely, when the corporation wrongfully cancels and transfers stock on its books, a settlement of its liability therefor gives rise to a deduction.²³⁰

When a retiring partner demands payment for his share of the good will of the business, to which the other partners insist he is not entitled under their agreement, and they make a payment to him "to avoid litigation," no deductible expense or loss results, for the continuing partners thereby increase their interest in the business.²³¹

business expense. Whether it would be allowed as a *loss* if the contract, although connected with business, did not concern the current carrying on of the business, or if connected with a non-business transaction entered into for profit, does not appear to have been decided. See *supra* note 222.

²²⁵I. T. 1182, I-1 CUM. BULL. 142 (1922) (liability of National Guard officer for shortage in accounts).

²²⁶Respecting violations of the anti-trust laws, see *infra* note 237.

²²⁷One Hundred Five West Fifty-Fifth Street, Inc. v. Comm'r, 42 F. (2d) 849 (C. C. A. 2d 1930).

²²⁸Newark Milk & Cream Co. v. Comm'r, 34 F. (2d) 854 (C. C. A. 3d 1929); A. R. R. 701, 5 CUM. BULL. 176 (1921). Cf. Burt L. Davis, 26 B. T. A. 218 (1932) (partnership). But cf. Murray Hospital v. Rasmussen, 20 F. (2d) 29 (C. C. A. 9th 1927), in which vexatious suits by a stockholder were settled by purchase of his stock at a price well above that fixed in the by-laws of the closed corporation, the excess being alleged to be a payment merely for freedom from strife rather than for an asset; on demurrer, this was held a good allegation of a business loss, but it was not established on the trial, which resulted in a directed verdict against the taxpayer [see 35 F. (2d) 864 (C. C. A. 9th 1929)].

²²⁹North American Investment Co., 24 B. T. A. 419 (1931) (NA).

²³⁰Superheater Co., 12 B. T. A. 5 (1928) (A), *aff'd on other grounds*, 38 F. (2d) 69 (C. C. A. 2d 1930). The Board did not decide whether it was an expense or a loss.

²³¹Arthur P. Williams, 24 B. T. A. 1070 (1931). The Board rested upon its construction of the partnership contract and the law, holding that the retiring partner actually had a right to payment for good will. A different result might follow if it should find the claim unfounded. Cf. A. King Aitkin, 12 B. T. A. 692 (1928) (NA); Charles F. Mosser, 27 B. T. A. 513 (1933) (NA) (amounts paid to partner in excess of his interest, to obtain prompt dissolution, held deductible). Cf. also North American Investment Co., *supra* note 229.

In partnerships and closely held corporations particularly, the personal and family quarrels and litigations of an officer may have such an adverse effect upon the fortunes of the organization that the minority members consent to a settlement by the corporation. Such payments, although legalized by the assent of all parties interested, are in the nature of a diversion of corporate or partnership assets for the personal benefit of a member, and are not deductible.²³² Similarly, if a corporation pays a judgment or claim against an officer, for which it is not itself liable, the payment is not deductible no matter whether it could have been deducted by the officer, if he had paid it.²³³ A payment to an officer to induce him to resign has been held not deductible in the absence of proof that it is reasonable additional compensation.²³⁴

The civil liabilities of directors and officers of corporations for fraud, secret profits, negligence, and the like, arise out of their business of managing the corporation, and are deductible by them.²³⁵ On the other hand, the statutory liabilities of stockholders for the losses and liabilities of banks and other corporations are in the nature of additional investment of capital, and may not be deducted until their stock becomes wholly worthless or a loss is finally realized by a sale.²³⁶

²³²*White v. Comm'r*, 61 F. (2d) 726 (C. C. A. 9th 1932); *Forty-Four Cigar Co.*, 2 B. T. A. 1156 (1925). Cf. *George D. Mann*, 33 B. T. A. 281 (1935) (NA). The fact that the activities of the opposing party would have ruined the organization's business if continued does not change the essential character of the payment as a personal expense of the officer. *Forty-Four Cigar Co.*, *supra*. The fact that the settlement enables the officers to serve the organization without interruption and harassment may possibly make the payment one in the nature of additional compensation to the officers, deductible upon a proper showing that their total compensation, including this payment, is reasonable. See *Blackwell Oil & Gas Co.*, 20 B. T. A. 661, 665 (1930), *aff'd*, 60 F. (2d) 257 (C. C. A. 10th 1932) (Board rejected this claim for lack of evidence that officers were not otherwise reasonably compensated).

²³³*Blackwell Oil & Gas Co. v. Comm'r*, 60 F. (2d) 257 (C. C. A. 10th 1932), *aff'g* 20 B. T. A. 661 (1930) (suit against directors for malicious conspiracy to prevent stockholders from carrying out an option contract; by resolution of same directors, corporation assumed liability and made settlement; corporation was no party to conspiracy and was not liable, so may not deduct); *San-Knit-Ary Textile Mills, Inc.*, 22 B. T. A. 754 (1931) (corporation settled judgment against president for automobile accident, not shown to have been on corporate business). Cf. *Welch v. Helvering*, 290 U. S. 111, 54 Sup. Ct. 8 (1933) (payment of another's debts, even for good business reason, is not ordinary and necessary business expense).

²³⁴*National Cottonseed Products Corp. v. Comm'r*, 76 F. (2d) 839 (C. C. A. 6th 1935). Cf. *Lewis Spencer Morris, Trustee*, 40 B. T. A. 987 (1939), in which a similar expense was held not to be "ordinary and necessary" in any event, and not to be compensation for services since no more services were to be rendered.

²³⁵*O. D.* 1091, 5 CUM. BULL. 139; I. T. 1853, II-2 CUM. BULL. 124 (1923); cf. *Charles R. Stuart*, 38 B. T. A. 1147 (1938). See *infra* note 364. Public policy does not prevent deduction of such liabilities, other than liabilities to the Government. See *Torts, infra*.

But cf. *McGinn v. Comm'r*, 76 F. (2d) 680 (C. C. A. 9th 1935), arising under the provision for the carry-over of losses.

²³⁶*First National Bank in Wichita v. Comm'r*, 46 F. (2d) 283 (C. C. A. 10th 1931);

Crimes: Fines and penalties paid to a government are not deductible even though they arise out of one's business.²³⁷ It has been so held even with respect to civil penalties for violations involving no elements of wilfulness, negligence, or bad faith, although such violations may be to some extent inevitable in the normal course of the taxpayer's business.²³⁸ For it is said that unlawful acts are no part of the taxpayer's ordinary business, and the same public policy which imposes a fine or penalty for acts involving no wrongful intent forbids the deduction of such payments from taxable income.

Domestic Relations: Payments made and judgments suffered on account of breach of promise to marry are personal in nature and may not be deducted.²³⁹ Similarly, alimony payments and payments for the support of children are not deductible.²⁴⁰ Furthermore, the income of an alimony trust

Harry E. Lutz, 2 B. T. A. 484 (1925); John G. Paxton, 7 B. T. A. 92 (1927); Porter Property Trustees, Ltd., 42 B. T. A. No. 103 (1940); Regulations 103, sec. 19.24-2; O. D. 918, 4 CUM. BULL. 213 (1921). *But cf.* Charles R. Stuart, 38 B. T. A. 1147 (1938), allowing deduction of a judgment for taxpayer's liability (upon what theory is not stated) as a director for the defalcations of another.

Such liabilities are deductible if the stock is worthless and is not rehabilitated by the assessment. I. T. 2843, XIV-1 CUM. BULL. 77 (1935). The loss is then an ordinary loss rather than a capital loss. I. T. 3351, 1940-1 CUM. BULL. 87.

²³⁷Fines for violations of anti-trust and price-fixing statutes: Burroughs Bldg. Material Co. v. Comm'r, 47 F. (2d) 178 (C. C. A. 2d 1931); Columbus Bread Co., 4 B. T. A. 1126 (1926).

Prohibition law violations connected with business: Bonnie Bros., Inc., 15 B. T. A. 1231 (1929); *cf.* B. E. Levinstein, 19 B. T. A. 99 (1930).

Civil penalties for violations by railroads of federal safety appliance, hours of service, livestock transportation, and quarantine laws, and customs regulations: Great Northern Ry. v. Comm'r, 40 F. (2d) 372 (C. C. A. 8th 1930), *cert. denied*, 282 U. S. 855, 51 Sup. Ct. 31 (1930); Chicago, R. I. & P. Ry. v. Comm'r, 47 F. (2d) 990 (C. C. A. 7th 1931), *cert. denied*, 284 U. S. 618, 52 Sup. Ct. 7 (1931); Tunnel R. R. v. Comm'r, 61 F. (2d) 166 (C. C. A. 8th 1932), *cert. denied*, 288 U. S. 604, 607, 53 Sup. Ct. 396, 398 (1933); S. R. 1448, IV-1 CUM. BULL. 140 (1925).

Cf. contra: Huff, Andrews & Thomas, 1 B. T. A. 542 (1925) (A), in which a wholesale grocer allegedly violated the Lever Food Control Act; investigators threatened to deprive him of his license unless he gave \$5,000 to such war charities as the Food Administrator might select (hence, not strictly in the nature of a fine or penalty); held deductible.

²³⁸See the railroad cases cited in the preceding footnote, and Bonnie Bros., Inc., also cited therein.

²³⁹Regulations 103, sec. 19.24-1; O. D. 546, 2 CUM. BULL. 157 (1920).

²⁴⁰J. A. L. Van den Bosch, 26 B. T. A. 679 (1932) (alimony); Regulations 103, sec. 19.24-1. *Cf.* the cases cited *infra* notes 241 and 242. Interest upon an alimony obligation is also held non-deductible. Longyear v. Helvering, 77 F. (2d) 116, 64 App. D. C. 238 (1935).

Even though the children are with the divorced wife, however, the husband rather than the wife has the benefit of the dependent exemption if his contributions furnish their chief support, whether or not a *specific portion* of the alimony was segregated for their use by the decree or settlement, provided that the decree or settlement purports to make provision for such support. P. L. Taylor, 11 B. T. A. 441 (1928) (A); M. A. Willem, 39 B. T. A. 898 (1939) (A); I. T. 2096, III-2 CUM. BULL. 163 (1924) (denying deduction where decree did not mention support of children); I. T. 3274, 1939-1 CUM. BULL. 177 (granting deduction where support of children was provided for in decree, although in no specific amount). *Cf.* Eleanor L. Mack, 37 B. T. A. 1101 (1938)

set up for a divorced or separated wife by the husband is held to discharge his continuing obligation to her, and, with exceptions fully considered in Part One, is taxable to the husband.²⁴¹ The income of trusts set up to dis-

(denying exemption to wife in such circumstances). Whether the divorced husband may claim exemption as head of a family depends upon the circumstances of each case. See Meier S. Block, 37 B. T. A. 945 (1938) (NA); Sidney Williamson Kirtland, 39 B. T. A. 959 (1939) (A); O. D. 754, 3 CUM. BULL. 195 (1920); I. T. 2354, VI-1 CUM. BULL. 75 (1927).

When a husband, to obtain an absolute discharge of his obligation to support his wife (who is suing him for a divorce), transfers to her property which cost him much less than its present value, it is held that no taxable gain is realized by him, although if he had sold the property and given her the proceeds, such a gain would have resulted; the reason given is that it is impossible to place a market value on the marital obligation from which he is released in exchange for the property. L. W. Mesta, 42 B. T. A. No. 135 (1940).

²⁴¹Douglas v. Willcutts, 296 U. S. 1, 56 Sup. Ct. 59 (1935); Helvering v. Fitch, 309 U. S. 149, 60 Sup. Ct. 427 (1940); Helvering v. Leonard, 310 U. S. 80, 60 Sup. Ct. 780 (1940).

It is now established that the ex-husband is *not* taxable upon the income of an alimony trust if, but only if, he absolutely and irrevocably discharged his marital obligation by setting up the trust; it is requisite that he shall not have guaranteed, even contingently, the income from the trust and that, by local law and the terms of the decree and the settlement, the court has no power to modify the decree. Helvering v. Fuller, 310 U. S. 69, 60 Sup. Ct. 784 (1940) (husband not taxable, in view of Nevada law and the terms of the trust). The burden is upon the taxpayer to establish the local law by "clear and convincing proof." Helvering v. Fitch, *supra* (husband taxable; Iowa law); Helvering v. Leonard, *supra* (husband taxable; New York law). Later applications of those principles are found in Dixon v. Comm'r, 109 F. (2d) 984 (C. C. A. 3d 1940) (Pennsylvania law provided no alimony; trust provided fixed payments from income and principal, but husband agreed conditionally to assign only a *limited amount* of securities to trust if income fell below agreed amount; held *not* taxable to husband); Weir v. Comm'r, 109 F. (2d) 996, 999 (C. C. A. 3d 1940), *cert. denied*, 310 U. S. 637, 60 Sup. Ct. 1080 (1940) (same state law, by which alimony could not be decreed, but husband guaranteed income of trust; husband held taxable); Tilles v. Comm'r, 113 F. (2d) 907 (C. C. A. 8th 1940), *cert. denied*, 61 Sup. Ct. 143 (1940) (trust held to be mere pledge to secure guaranteed income; immaterial, therefore, that alimony could not have been decreed under state law; husband taxable); Arthur Letts, Jr., 41 B. T. A. 1172 (1940) (A) (Nevada law and trust agreement terminated all obligation, no guarantee of income and no power in court to modify decree; husband held not taxable); William H. Stanley, 41 B. T. A. 1233 (1940) (A) (obligation terminated under Illinois law and terms of trust; husband not taxable); Susan Sturgis Barry, 42 B. T. A. 1 (1940) (obligation terminated under Maine law and terms of trust; *wife* taxable); Harold Ingraham, 42 B. T. A. 44 (1940) (failed to meet burden of proving termination of obligation under Connecticut law; husband taxable); Josephine S. Pearce, 42 B. T. A. 91 (1940) (agreement provided that purchase of annuity for wife should discharge obligation, and Commissioner found that discharge was final under Texas law; *wife* failed to overcome finding and was held taxable); Murray Innes, 42 B. T. A. 93 (1940) (no guarantee of income, but California law permitted court to modify decree or agreement; husband held taxable); Harry T. Nicolai, 42 B. T. A. No. 131 (1940) (husband set up trust of stock in controlled corporation, agreeing to cause corporation to declare certain dividends but only "from available net earnings"; held that agreement and Oregon law finally discharged his marital obligation; husband not taxable); William E. Walter, 42 B. T. A. No. 136 (1940) (obligation fully discharged by Pennsylvania law and by terms of settlement of litigation over trust). See full discussion in Part One, (Feb. 1940) 25 CORNELL L. O. 221, 235-238.

It should be noted that *Clifford v. Helvering*, cited in notes 96, 97, and 100 thereof, respecting a trust for a term, over which the grantor retains substantial control, was re-

charge the divorced father's obligation to support his children is also taxable to him.²⁴² Although the question is disputed, it would appear that payments to one's wife, whether or not in connection with a divorce, in consideration for her release of her inchoate rights in the husband's property may not be added to the cost of the property or deducted from the proceeds;²⁴³ the contrary rule would, in effect, permit a deduction on account of a transfer of a property interest resulting from marriage, from which relationship it has often been held that no gain or loss (for purposes of income tax) is derived.²⁴⁴

Labor Law: Awards of back wages made by the National Labor Relations Board are deductible business expenses.²⁴⁵

Mortgages: Losses sustained by a mortgagor upon the foreclosure of a mortgage are deductible when the mortgaged property is business property or was purchased or used for purposes of profit, but not when it is residential or similar property.²⁴⁶ The loss, if deductible, is the adjusted cost

versed in *Helvering v. Clifford*, 309 U. S. 331, 60 Sup. Ct. 554 (1940). However, the mere existence of a reversion in the husband, if on the facts of the case he is not regarded as "in substance the owner" in the interim, does not make him taxable upon the income if he meets the terms of the *Fuller* case, since a reversion is not a "power to reversion" within the meaning of § 166 of the Code. *Helvering v. Wood*, 309 U. S. 344, 60 Sup. Ct. 551 (1940); *Comm'r v. Tuttle*, 89 F. (2d) 112 (C. C. A. 6th 1937); *Lolita S. Armour*, 41 B. T. A. 777 (1940); I. T. 3238, 1938-2 CUM. BULL. 204. See also the remarks of Justice Douglas in the *Fuller* case upon the effect of the husband's retaining voting rights in the stocks in the trust (which point, however, had not been properly raised).

²⁴²*Helvering v. Schweitzer*, 296 U. S. 551, 56 Sup. Ct. 304 (1935); *Helvering v. Leonard*, 105 F. (2d) 900, 903 (C. C. A. 2d 1939), *rev'd on other grounds*, 310 U. S. 80, 60 Sup. Ct. 780 (1940); *Harry S. Blumenthal*, 34 B. T. A. 994 (1936), *aff'd on other grounds*, 91 F. (2d) 1009 (C. C. A. 2d 1937); *Ernestine Mitchell*, 38 B. T. A. 1336 (1938); *Arthur Letts, Jr.*, 41 B. T. A. 1172 (1940); *Harold Ingraham*, 42 B. T. A. 44 (1940). Even in those cases which held the income of the alimony trust under consideration not taxable to the husband, under the exceptions referred to in the text, because there remained no obligation to the wife, nevertheless, so far as the income is allocable to *child support*, the husband is taxable, since he cannot commute or discharge that obligation. *Cf. also* G. C. M. 18972, 1937-2 CUM. BULL. 231.

²⁴³*Frank J. Digan*, 35 B. T. A. 256 (1937). *Contra: Frank v. Comm'r*, 51 F. (2d) 923 (C. C. A. 3d 1931).

Cf. S. George Ullman, Exec'r, 6 B. T. A. 100 (1927) (*Rudolph Valentino*, seeking divorce from Jean Acker, paid her \$12,000 for release of her expectant community rights in the income of a certain film contract; he soon abandoned the film contract so he got the worst of the bargain; he claimed the difference as a loss in a "transaction entered for profit," but it was denied that a transaction thus arising from the marriage relationship was such); *Frances R. Walz, Adm'x*, 32 B. T. A. 718 (1935) (no loss deductible upon division of community property).

²⁴⁴*See Fidelity & Columbia Trust Co. v. Lucas*, 11 F. Supp. 537, 539 (W. D. Ky. 1935), *aff'd on other grounds*, 89 F. (2d) 945 (C. C. A. 6th 1937). The basic case is *Gould v. Gould*, 245 U. S. 151, 38 Sup. Ct. 53 (1917).

²⁴⁵*I. T. 3412*, (Sept. 23, 1940) I. R. BULL. No. 39, p. 5.

²⁴⁶*Lloyd Jones*, 39 B. T. A. 531 (1939). The case also summarizes the rules for treating losses upon property which has been used both for residential and profit purposes during the time it was held.

Quaere, if residential property were mortgaged to obtain funds for business or invest-

basis²⁴⁷ of the property plus the amount of any deficiency judgment or payment, less the amount due upon the mortgage.²⁴⁸ The question whether a loss upon foreclosure is a capital loss or an ordinary loss, if "capital assets," as defined in the Code,²⁴⁹ are involved, is in confusion.²⁵⁰ The Supreme

ment; in such a case, the mortgage is part of a business transaction or a transaction entered into for profit, rather than a purely personal matter, and it might be held that any loss directly traceable to the mortgage and its foreclosure would be deductible; depreciation and normal market decline, as distinguished from forced sale loss, could not be deducted [cf. *Helvering v. Owens*, 305 U. S. 468, 59 Sup. Ct. 260 (1939)]. No case has considered the question, however.

²⁴⁷Internal Revenue Code § 113.

²⁴⁸*John O. Fowler*, 40 B. T. A. 1292 (1939) (NA). If, of course, the mortgage does not represent capital received but was given on account of business expenses for which no deduction has been taken (the taxpayer being on the cash basis), the amount due upon the mortgage will also be deductible when thus discharged.

²⁴⁹Internal Revenue Code § 117 (a) (1).

²⁵⁰A capital loss must result from a "sale or exchange." It is the position of the Board of Tax Appeals that a "sale or exchange" requires the assent of the parties and a consideration moving to the seller. *Lloyd Jones*, 39 B. T. A. 531 (1939) (NA).

Therefore, if the taxpayer is personally liable on the mortgage debt (or other obligation), a capital loss is sustained if he voluntarily conveys or quitclaims the property for a consideration of complete or partial release. [*Estate of Will Rogers v. Comm'r*, 103 F. (2d) 790 (C. C. A. 9th 1939), *cert. denied*, 308 U. S. 580, 60 Sup. Ct. 98 (1939); *Pender v. Comm'r*, 110 F. (2d) 477 (C. C. A. 4th 1940), *cert. denied*, 60 Sup. Ct. 1103 (1940); *Wieboldt v. Comm'r*, 113 F. (2d) 384 (C. C. A. 7th 1940); *Harold R. Smith*, 39 B. T. A. 892 (1939); *C. L. Grandsden & Co.*, 39 B. T. A. 985 (1939). Cf. *Philips v. Comm'r*, 112 F. (2d) 721 (C. C. A. 3d 1940). *But cf. Park Chamberlain*, 41 B. T. A. 10 (1940) (NA), on appeal, C. C. A. 7th (taxpayer, personally liable on mortgage, voluntarily surrendered his interest to co-adventurer, who hoped to rehabilitate it; Board found no agreement by transferee to assume liability, hence no consideration and no sale, but rather an abandonment of a worthless asset; held, an ordinary loss). An additional payment by the debtor on account of a deficiency is held, however, to be an ordinary loss. *C. L. Grandsden & Co.*, *supra*.

If property is taken by foreclosure, and a personal liability is satisfied thereby, the cases are in disagreement whether the involuntary transfer is equivalent to a sale or exchange. The Second Circuit holds it a sale, resulting in a capital loss. *Comm'r v. Electro-Chemical Engraving Co.*, 110 F. (2d) 614 (C. C. A. 2d 1940), *cert. granted*, 310 U. S. 622, 60 Sup. Ct. 1097 (1940). The Sixth Circuit and the Board hold it an ordinary loss. *Comm'r v. Hammett*, 108 F. (2d) 753 (C. C. A. 6th 1940), *cert. granted*, 310 U. S. 619, 60 Sup. Ct. 1077 (1940); *C. Griffith Warfield*, 38 B. T. A. 907 (1938) (NA); *H. L. Rust, Jr.*, 38 B. T. A. 910 (1938) (NA), *appeal dismissed*, 105 F. (2d) 1017 (C. C. A. 4th 1939); *Lloyd Jones*, *supra*; *Sherwin A. Hill*, 40 B. T. A. 376 (1939) (NA); *John O. Fowler*, 40 B. T. A. 1292 (1939) (NA). Cf. *Nebraska Bridge Supply & Lumber Co.*, 40 B. T. A. 40 (1939) (NA); *Street v. Welch*, 30 F. Supp. 394 (D. Mass. 1939) (involving tax foreclosures). If, following foreclosure, the taxpayer quitclaims in order to cut off his right of redemption or perfect the title, the loss is nevertheless treated by the Board as an ordinary loss by foreclosure. *Sherwin A. Hill*, *supra*. When the extinction of taxpayer's title is accomplished by a forfeiture declared by the vendor under a land contract, rather than by a voluntary reconveyance, the loss is held to be an ordinary loss, irrespective of whether the parties subsequently exchange a quitclaim for a release of liability (both purposes having been accomplished by the forfeiture itself). *C. G. Ganoups*, 39 B. T. A. 1120 (1939) (NA).

If the taxpayer holds merely subject to a mortgage and is not personally liable for the debt, it is held that an ordinary loss results whether the transfer is voluntary or by foreclosure, since there is no release of liability to constitute a consideration for the extinction of the taxpayer's equity. *Comm'r v. Frehofer*, 102 F. (2d) 787, 125 A. L. R. 761 (C. C. A. 3d 1939), *aff'g Sol Greisler*, 37 B. T. A. 542 (1938) (NA) (foreclosure); *Street*

Court, at the present term, may be expected to clear up the conflicts and the subtle distinctions which now exist.²⁵¹

*Negotiable Instruments.*²⁵²

Property: When an action involves the right to property, even though connected with one's business, the deductibility of payments made or liabilities incurred by the taxpayer, if they result in the acquisition or retention of the property, is denied on the ground that they are capital expenditures, to be added to the cost.²⁵³ Amounts paid in settlement of a will contest also are

v. Welch, 30 F. Supp. 394 (D. Mass. 1939) (foreclosure); Commonwealth, Inc., 36 B. T. A. 850 (1937) (NA) (voluntary conveyance); Realty Operators, Inc., 40 B. T. A. 1050 (1939) (NA) (after foreclosure was commenced, taxpayer's directors voted to surrender title, and so notified mortgagee, but no formal transfer was made until foreclosure). Cf. Polin v. Comm'r, (C. C. A. 3d 1940) 114 F. (2d) 174 (terms of mortgage limited liability to the mortgaged property; voluntary surrender held not a sale). However, if any actual consideration is given for a voluntary transfer, the transaction is converted into a sale and the entire loss is a capital loss. Harry C. Aberle, 41 B. T. A. 863 (1940) (mortgagee assumed property taxes which accrued during negotiations, which are a personal liability in Pennsylvania). A consideration covering merely the stamps for the deed and the personal property left upon the premises does not make the transaction a sale of the mortgaged property (if taxpayer was not personally liable). Commonwealth, Inc., *supra*. A formal recital of one dollar as consideration is immaterial if there is no actual consideration. Park Chamberlain, 41 B. T. A. 10 (1940) (NA), on appeal, C. C. A. 7th.

The Bureau holds that in all cases such losses are capital losses, deductible only subject to the restrictions of Section 117 of the Code. G. C. M. 12737, XIII-1 CUM. BULL. 120 (1934) (foreclosure where there was personal liability); and non-acquiescence in above cases, as indicated.

Of course, when the assets concerned are not "capital assets", the losses are not capital losses in any event. This applies to stock in trade, property held primarily for sale to customers in the ordinary course of trade or business, and (since 1938) property used in trade or business which is subject to a depreciation allowance. Internal Revenue Code § 117 (a) (1); Regulations 103, sec. 19.117-1.

²⁵¹*Certiorari* has been granted on two conflicting cases relating to loss by foreclosure where the taxpayer was personally liable for the debt (*supra* note 250). No case is before the Court in which the taxpayer held property *subject* to a mortgage, but it is to be hoped that the Supreme Court will lay down a principle which will cover such cases.

²⁵²See *Suretyship and Guaranty, infra*.

²⁵³*Murphy Oil Co. v. Burnet*, 55 F. (2d) 17, 25 (C. C. A. 9th 1932), *aff'd on other grounds*, 287 U. S. 299, 53 Sup. Ct. 161 (1932) (seller sued taxpayer-purchaser to rescind for fraud; settled and taxpayer kept land upon paying more; although rescission was asked, settlement affirmed sale to taxpayer and was "deferred payment" for land); *Blackwell Oil & Gas Co. v. Comm'r*, 60 F. (2d) 257 (C. C. A. 10th 1932) (compromise of title dispute); *Brawner v. Burnet*, 63 F. (2d) 129, 61 App. D. C. 352 (1933) (compromise of suit to set aside transfer for incapacity and undue influence); *Earl M. Palmer*, 3 B. T. A. 403 (1926) (A) (taxpayer held title for another, was accused of abusing trust, settled suit by payment whereby full title was acquired); *Shaw-Hayden Bldg. Co.*, 18 B. T. A. 949 (1930); *Sunburst Oil & Refining Co.*, 23 B. T. A. 829 (1931); *R. S. Goforth*, 32 B. T. A. 1206 (1935) (NA), *appeals dismissed*, 84 F. (2d) 1003 and 86 F. (2d) 1000 (C. C. A. 10th 1936) (payment in settlement of title suit held part of cost basis); *A. R. R. 6972*, III-1 CUM. BULL. 203 (1924). *But cf.* *Grace McBride Crile*, 26 B. T. A. 1020 (1932) (NA) (defense of suit to invalidate trust for violation of rule against perpetuities; settlement held deductible).

The property is deemed to have been *acquired*, for purposes of the capital gain and loss provisions, at the time it was purchased and not when a further sum was paid in

so treated.²⁵⁴ When a person to whom an alleged fraudulent conveyance has been made settles by making a payment to the protesting creditors, the payment merely reduces the property to its unencumbered value and is not a loss.²⁵⁵ However, when a building owner, having paid his contractor, is compelled to make further payments to lift materialmen's liens, the payments add nothing to the cost or value of the building and are not capital expenditures; the taxpayer is paying the debts of another, against whom he has a right of reimbursement, and he may deduct a bad debt if and when he ascertains that right to be worthless and charges it off.²⁵⁶

Suretyship and Guaranty: When a surety, guarantor, or indorser discharges his secondary liability, it does not *per se* give rise to a deductible loss or expense. He has a right of reimbursement against the principal debtor, and he must ascertain that that right is worthless and charge it off as a bad debt.²⁵⁷ That rule benefits the taxpayer, however, in that one who indorses or guarantees another's note from purely personal, non-profit motives or who is compelled to pay off materialmen's liens upon his residence is enabled to take a deduction, whereas he could not do so if the payment were deemed a loss or expense.²⁵⁸ If, on the other hand, the taxpayer assumed

settlement of a title dispute. *See* R. S. Goforth, *supra*, at 1214.

If the settlement is made after the property is disposed of, it may not be related back to reduce the gain or increase the loss upon the disposition but must be taken as a loss when the settlement is made. *Frederick S. Buggie*, 32 B. T. A. 581 (1935).

²⁵⁴*Klein v. Comm'r*, 84 F. (2d) 310 (C. C. A. 7th 1936) (even though payment was spread as an annuity, there was no basis for taking an annual deduction).

When a legatee, to forestall a will contest, agrees to pay over to the contestant a portion of the income of a trust, the income is nevertheless taxable to the legatee, in the absence of an assignment of a property interest. *Brewster v. United States*, 9 F. Supp. 688, 80 Ct. Cl. 614 (1935); *but cf. Shellabarger v. United States*, 38 F. (2d) 566 (C. C. A. 7th 1930). An assignment of a property interest, even though framed as an assignment of income, will prevent taxability of the income to the assignor, and no question of deduction will arise. *Blair v. Comm'r*, 300 U. S. 5, 57 Sup. Ct. 330 (1937).

²⁵⁵*Langford Investment Co. v. Comm'r*, 77 F. (2d) 468 (C. C. A. 5th 1935), *aff'g* 28 B. T. A. 222 (1933).

²⁵⁶*Leichner & Jordan Co.*, 4 B. T. A. 133 (1926) (A); *Lena G. Hill*, 8 B. T. A. 1159 (1927) (A). *But cf. O. D.* 925, 4 CUM. BULL. 213 (1921) (payment held part of cost of building; presumably superseded by acquiescence in the *Leichner* case).

²⁵⁷*Milton H. Bickley*, 1 B. T. A. 544 (1925) (A) (payment on guaranty gives rise to deduction when principal subsequently becomes insolvent, not when payment was made); *Leichner & Jordan Co.*, 4 B. T. A. 133 (1926) (A) (building owner paid materialmen, to avoid foreclosure of liens; deductible at once since contractor insolvent); *J. P. Badenhausen*, 7 B. T. A. 910 (1927); *Lena G. Hill*, 8 B. T. A. 1159 (1927) (A) (similar to *Leichner* case but no showing of insolvency of contractor; not deductible); *H. Rodney Sharp*, 38 B. T. A. 166 (1938) (A) (guaranteed brokerage account for friend, paid off when friend insolvent; deductible as bad debt, since reimbursement had been expected and no gift was intended); *Whitcher v. Welch*, 22 F. Supp. 763 (D. Mass. 1938); *A. R. R.* 479, 5 CUM. BULL. 146 (1921).

²⁵⁸*H. Rodney Sharp*, 38 B. T. A. 166 (1938) (A); *D. W. Pierce*, 41 B. T. A. 1261 (1940) (A); *Alice du Pont Ortiz*, 42 B. T. A. 173 (1940) (A).

With respect to the effect of the distinction upon the time for taking the deduction, see *infra* notes 340-342.

secondary liability when there was at the time no prospect of payment by the principal debtor, it is deemed a gift, although it *may* be that a loss could be deducted if good business reasons could be shown for the transaction.²⁵⁹ Similarly, if a contract is simply one of indemnity against loss, carrying with it no right of reimbursement or subrogation, a payment thereon gives rise only to a loss, which may be deducted if the transaction was entered for profit or in the course of one's business, but not otherwise.²⁶⁰ If a surety, guarantor, or indorser, instead of paying his obligation, merely purchases his release therefrom, so that the creditor retains the principal obligation and the taxpayer has no right of subrogation, there is no debt which he can charge off, and he must deduct the payment, if at all, as a loss.²⁶¹

Taxation: With the exceptions specified in the statute,²⁶² all taxes paid or accrued are, of course, deductible whether or not the liability was litigated,²⁶³ at least if the tax was constitutionally levied.²⁶⁴ But *penalties*

²⁵⁹*M. A. Burns Mfg. Co. v. Comm'r*, 59 F. (2d) 504 (C. C. A. 9th 1932) (loss allowed, where obligation was assumed to help taxpayer's own credit). *But cf. Welch v. Helvering*, 290 U. S. 111, 54 Sup. Ct. 8 (1933), where the Court disallowed a loss to a corporate officer who paid the debts of his bankrupt corporation, declaring that the payment of another's debt to establish one's own credit is not ordinary business conduct.

²⁶⁰*Yoder v. Nauts*, 34 F. (2d) 450 (N. D. Ohio 1928) (deductible as business loss); *Howell v. Comm'r*, 69 F. (2d) 447 (C. C. A. 8th 1934) (not deductible as bad debt). *Cf. Marjorie Fleming Lloyd-Smith*, 40 B. T. A. 214, 222 (1939) (details of transaction not clear; held deductible as loss in transaction entered into for profit).

²⁶¹*John P. Dillon*, 9 B. T. A. 177 (1927) (NA) (taxpayer guaranteed new investors in bank against loss upon assets taken over; later bought release, leaving bank with the beneficial interest in the assets). But if the taxpayer makes the settlement as part of the rehabilitation of the principal debtor, in which he has the dominant interest, the payment is a capital expenditure rather than a loss or expense. *Menihan v. Comm'r*, 79 F. (2d) 304 (C. C. A. 2d 1935), *cert. denied*, 296 U. S. 651, 56 Sup. Ct. 368 (1935). *But cf. D. W. Pierce*, 41 B. T. A. 1261 (1940) (A) (indirect benefit to investment, where guaranty of another stockholder's debt prevented sale of securities depressing market; held, not a capital expenditure, hence deductible).

²⁶²Internal Revenue Code § 23 (c). No distinction is made between personal and business taxes or between capital and current transactions.

²⁶³A tax for which liability is assumed, or for which one becomes liable as a transferee, is not deductible, however. An *assumed* liability is part of the cost of the property; and *transferee* liability represents merely the repayment of property received subject to a trust. *Falk Corp. v. Comm'r*, 60 F. (2d) 204 (C. C. A. 7th 1932). See *Sigmund Spitzer*, 23 B. T. A. 776 (1931). *Cf. Automatic Sprinkler Co.*, 27 B. T. A. 160 (1932). *But cf. Comm'r v. Coward*, 110 F. (2d) 725 (C. C. A. 3d 1940).

²⁶⁴The Board formerly declared that an unconstitutional tax is void *ab initio* and might not be deducted as a *tax*, even though not refunded, although such a tax (if not refunded) might be taken as a *loss* or *expense*, subject to the restrictions imposed upon such deductions. *E. L. Bruce Co.*, 19 B. T. A. 777 (1930) (A); *Guitar Trust Estate*, 34 B. T. A. 857, 873 (1936). *But cf. Charles F. Fawcett*, 30 B. T. A. 908 (1934) (A). See similar declarations by the Bureau in *S. M. 4683*, V-1 CUM. BULL. 59 (1926); *I. T. 2578*, X-1 CUM. BULL. 119 (1931); *I. T. 2741*, XII-2 CUM. BULL. 43, 50 (1933). See Part One, note 72. The Board, however, has recently reversed its position, characterizing the "void *ab initio*" rule as "sound legal metaphysics" but not to be taken without qualification. It now holds that taxes paid pursuant to an unconstitutional law, and not refunded, are deductible as *taxes*. *Cartex Mills, Inc.*, 42 B. T. A. No. 130 (1940).

assessed in connection with taxes are ruled to be non-deductible upon the same theory that deduction of fines in criminal cases is denied.²⁶⁵

*Torts.*²⁶⁶ In general, tort judgments against a taxpayer are deductible if they proximately result from his trade or business.²⁶⁷ An occasional dictum has suggested that certain torts might involve such anti-social conduct that a deduction would be denied even though it came within the statutory language,²⁶⁸ but no case has actually denied a deduction upon this ground, and the cases have gone far in permitting deductions of judgments for wilful torts. Thus, it was declared in *Helvering v. Hampton*,²⁶⁹ in allowing the deduction of a judgment for fraud:

"Even if unethical conduct in business were extraordinary, restitution therefor is ordinarily expected to be made from the person in the course of whose business the wrong was committed."²⁷⁰

Although public policy forbids the deduction of criminal fines and penalties, the revenue will not sit in judgment upon the ethical quality of a private wrong.²⁷¹

Accordingly, a judgment or settlement arising out of the negligent operation of an automobile, whether the negligence is that of a servant or of the taxpayer himself, is deductible if the automobile was being operated on

The treatment of tax *refunds* is discussed in Part One, (Feb. 1940) 25 CORNELL L. Q. 221, 231-3. See also Mim. 3958, XI-2 CUM. BULL. 33 (1932).

Unconstitutional taxes which are resisted and never paid may not be accrued and deducted. *J. A. Dougherty's Sons, Inc.*, 42 B. T. A. No. 129 (1940); *Estate of David Davies*, 42 B. T. A. No. 140 (1940).

²⁶⁵G. C. M. 11358, XII-1 CUM. BULL. 29 (1933) (ruling that tax penalties are deductible neither as taxes nor as ordinary business expenses, whether imposed for fraud, delinquency, or mere negligence); *Helen B. Achelis et al.*, Exec'rs, 28 B. T. A. 244 (1933). In *United States v. Jaffray*, 97 F. (2d) 488 (C. C. A. 8th 1938), *aff'd on other grounds sub nom. United States v. Bertelsen & Peterson Co.*, 306 U. S. 276, 59 Sup. Ct. 541 (1939), it was said that certain *degrees* of negligence *might* be sufficiently "ordinary and necessary" to permit a deduction of the penalties therefor, but that the burden is upon the taxpayer to establish the fact. *Cf. B. E. Levinstein*, 19 B. T. A. 99 (1930) (NA) (levy held a tax rather than a penalty).

²⁶⁶See note (1936) 104 A. L. R. 680, 686.

²⁶⁷Respecting torts by directors and officers of corporations, see *Corporations, supra*.

²⁶⁸See *Anderson v. Comm'r*, 81 F. (2d) 457, 460 (C. C. A. 10th 1936); *Blackwell Oil & Gas Co.*, 20 B. T. A. 661, 665 (1930), *aff'd*, 60 F. (2d) 227 (C. C. A. 10th 1932); *International Shoe Co.*, 38 B. T. A. 81, 95 (1938); *I. T. 1853*, II-2 CUM. BULL. 124 (1923). Square holdings to the contrary are found in *Becker Bros. v. United States*, 7 F. (2d) 3 (C. C. A. 2d 1925); *Helvering v. Hampton*, 79 F. (2d) 358 (C. C. A. 9th 1935).

²⁶⁹79 F. (2d) 358, 361 (C. C. A. 9th 1935).

²⁷⁰The argument rests upon *Welch v. Helvering*, 290 U. S. 111, 114, 54 Sup. Ct. 8 (1933), in which it was said that although lawsuits are relatively rare in the life of a particular business, it is the ordinary course to retain an attorney when such a situation does arise.

²⁷¹Compare the rule respecting criminal fines and penalties. See *Crimes, supra*. That a civil liability for a tort against the *Government* may be treated like a fine rather than like a private tort liability is inferable from the cases on legal expenses cited *infra* notes 399 and 400.

business at the time,²⁷² but if it was not being operated on business, the liability may not be deducted.²⁷³ Liabilities to employees for injuries connected with one's business are deductible.²⁷⁴ But a judgment against a taxpayer for injuries resulting from the plaintiff's tripping over an obstruction in front of his residence may not be deducted.²⁷⁵

Liabilities resulting from the infringement of patents,²⁷⁶ from unfair competition,²⁷⁷ and from malpractice²⁷⁸ normally are connected with the taxpayer's business and hence are deductible. A judgment for trespass or conversion resulting from acts in the course of one's business is deductible.²⁷⁹ A statutory liability for usury, or a settlement on account of such liability, is not in the nature of a fine or penalty, since it is sued for by the borrower rather than by the State, and it is therefore deductible as a loss incurred in business or in a transaction entered for profit.²⁸⁰

A judgment for restitution or damages on account of the fraud of the taxpayer has been held deductible if the fraud was proximately connected with his business,²⁸¹ unless as a result of the judgment or settlement the

²⁷²Anderson v. Comm'r, 81 F. (2d) 457, 104 A. L. R. 680 (C. C. A. 10th 1936). The court declared that although *careless driving* is not a part of one's business, *driving* is, and lapses seem to be inseparable incidents of driving.

²⁷³It is not a loss of *property* from casualty, and therefore may not be deducted, even though the taxpayer's *own* property damages may be deducted (see *supra* note 216). L. Oransky, 1 B. T. A. 1239 (1925); B. M. Peyton, 10 B. T. A. 1129 (1928); Samuel E. Mulholland, 16 B. T. A. 1331 (1929); W. S. Dickason, 20 B. T. A. 496 (1930).

In San-Knit-Ary Textile Mills, Inc., 22 B. T. A. 754 (1931), a *corporation* was denied a deduction for such a liability although corporate loss deductions are not expressly restricted; however, it appears that the only judgment was rendered against the driver, which the corporation settled; lacking evidence that he was driving upon the business of the corporation, it could not be said that any corporate liability existed, and the payment appeared a voluntary one.

²⁷⁴Regulations 103, sec. 19.23 (a)-9.

²⁷⁵O. D. 779, 4 CUM. BULL. 155 (1921). It is not a loss of property from *casualty*. See *supra* note 216.

²⁷⁶Becker Bros. v. United States, 7 F. (2d) 3 (C. C. A. 2d 1925); Malleable Iron Range Co. v. United States, 65 Ct. Cl. 441 (1928).

²⁷⁷International Shoe Co., 38 B. T. A. 81 (1938) (A). The Board rested in part upon the fact that the suit was settled to avoid bad publicity, and no illegal acts were actually proven.

²⁷⁸Cf. S. M. 4078, V-1 CUM. BULL. 226 (1926), relating to attorney fees in such actions.

²⁷⁹Provident Coal Mining Co. v. Lucas, 39 F. (2d) 109 (W. D. Ky. 1930), *rev'd on other grounds*, 60 F. (2d) 86 (C. C. A. 6th 1932) (judgment for mining coal under another's land). Cf. Bliss v. Comm'r, 57 F. (2d) 984 (C. C. A. 5th 1932) (adverse possessor, when ejected, was awarded his oil drilling expenses, including the cost of dry holes, on the theory of implied authority; held that the cost of drilling the dry holes might be deducted just as if the drilling had been authorized.)

²⁸⁰W. R. Hervey, 25 B. T. A. 1282 (1932) (A). The case involved a non-business transaction entered for profit, and thus is square authority for deductibility of the judgment as a *loss*, not subject to the more restricted requirements for the deduction of expenses.

²⁸¹Helvering v. Hampton, 79 F. (2d) 358 (C. C. A. 9th 1935); H. M. Howard, 22 B. T. A. 375 (1931) (NA); O. D. 978, 5 CUM. BULL. 135 (1921); I. T. 1789, II-2

taxpayer reacquires or retains the property to which the fraud related, in which case the liability is added to the cost of the property and no present loss is sustained.²⁸²

A liability resulting from a suit for an accounting for a matter arising out of one's business may be deducted if it is income which is accounted for,²⁸³ but not if the plaintiff sought capital belonging to him which had been entrusted to the taxpayer²⁸⁴ (unless the taxpayer had previously properly reported it as income under the "claim of right" rule).²⁸⁵

*Trust and Estates:*²⁸⁶ When a trustee, executor, or administrator is surcharged for improper investments or incurs other liabilities, he may deduct the loss if he is engaged in the business of handling trusts and estates (or of handling the particular trust or estate if he is sufficiently active).²⁸⁷ If he merely manages a trust or estate for a relative without compensation, or if his activities are not sufficient to constitute a business, he may not take a deduction.²⁸⁸ Whether a payment by a beneficiary to induce a trustee or administrator to resign, in order to avoid litigation over his management of the estate, may be deducted, even if the trust or estate is engaged in business, is unsettled.²⁸⁹

* * * * *

When a judgment or a settlement covers two or more claims, the treatment of which for income tax purposes is different, the burden is upon the taxpayer to adduce evidence from which it may be determined how much is attributable to the deductible liability and, in the absence of such evidence, all

CUM. BULL. 121 (1923). The cases and rulings all involved *business* transactions, and there is no authority respecting non-business transactions entered for profit.

²⁸²Murphy Oil Co. v. Burnet, 55 F. (2d) 17, 25 (C. C. A. 9th 1932) (taxpayer purchased land; seller sued to rescind for fraud, but as a result of settlement taxpayer retained the land upon paying damages; damages held to be in the nature of a deferred payment for the land).

²⁸³Frederick McLean Bugher *et al.*, Exec'rs, 9 B. T. A. 1155 (1928) (A).

²⁸⁴Gwathmey v. Comm'r, 76 F. (2d) 754 (C. C. A. 2d 1935); Frederick McLean Bugher *et al.*, Exec'rs, 9 B. T. A. 1155 (1928) (A).

²⁸⁵*Supra*, Part 2 (a).

²⁸⁶Respecting the restoration of income which the taxpayer has improperly received from a trust, see *supra* note 191.

²⁸⁷John Abbott, 38 B. T. A. 1290 (1938) (A).

²⁸⁸Stuart v. Comm'r, 84 F. (2d) 368 (C. C. A. 1st 1936), *aff'g* 32 B. T. A. 574 (1935), *cert. denied*, 299 U. S. 575, 57 Sup. Ct. 38 (1936); Stephen H. Tallman, 37 B. T. A. 1060 (1938) (taxpayer was engaged in banking business but did not act in that capacity, managing finances of relative voluntarily).

Respecting when the management of investments constitutes a business, see cases cited *infra* notes 369-372.

²⁸⁹Payment was allowed as a deduction in Mary D. Moore Holifield, 7 B. T. A. 1302 (1927), where administratrix had been mismanaging an estate consisting of business property and the estate was being wasted in litigation. A similar payment was disallowed in Lewis Spencer Morris, Trustee, 40 B. T. A. 987 (1939), holding that even if it were a business expense, it was not "ordinary and necessary."

doubts will be resolved against the deduction.²⁹⁰ In any settlement where the defendant is in a position to do so, he should insist that the settlement be apportioned.

Interest upon indebtedness is deductible, with an exception not here material, irrespective of the origin of the debt,²⁹¹ and a judgment is a debt; hence, interest *upon* a judgment is deductible whether or not the judgment itself is of a deductible kind.²⁹² The interest *included in* a judgment may, of course, be deducted if the judgment itself is deductible, but not otherwise unless the claim upon which the judgment is based is in the nature of a *debt*.²⁹³

When the defendant is held liable upon an obligation which he has *assumed* in connection with the acquisition of assets, the liability is of a capital nature and may not be deducted; it must be added to the cost of the property in connection with which the obligation was assumed.²⁹⁴ However, it *may* be

²⁹⁰In *Frederick McLean Bugher et al., Exec'rs*, 9 B. T. A. 1155 (1928) (A), the Board was presented with sufficient extraneous evidence to apportion a lump sum settlement of capital and income claims. In *O'Day Investment Co.*, 13 B. T. A. 1230 (1928) (A), the taxpayer was sued upon certain notes (non-deductible) and other claims of a business nature; a lump sum settlement of all claims was made; although he had denied liability upon the notes, there was no evidence of how much of the settlement was allocable thereto, and the Board subtracted the maximum (*i.e.*, face) as allocable to the notes and allowed deduction of the balance. In *Blackwell Oil & Gas Co. v. Comm'r*, 60 F. (2d) 257, 258 (C. C. A. 10th 1932) and *Luther Wallin*, 32 B. T. A. 697 (1935), there was no basis in the evidence for apportioning between deductible and non-deductible liabilities, so no deduction was allowed. Cf. *Brush-Moore Newspapers, Inc. v. Comm'r*, 95 F. (2d) 900 (C. C. A. 6th 1938), *cert. denied*, 305 U. S. 615, 59 Sup. Ct. 74 (1938), giving weight to the practical construction of a settlement agreement by the parties in their subsequent dealings—at least when it is unfavorable to the taxpayer's contention; no apportionment question was involved, however.

Cf. *Burnet v. Houston*, 283 U. S. 223, 228, 51 Sup. Ct. 413 (1931); *Cohan v. Comm'r*, 39 F. (2d) 540, 543 (C. C. A. 2d 1930). See also *infra* note 452 (apportionment of attorney's fees) and Part One, notes 106 and 107 (apportionment of recoveries by plaintiff).

²⁹¹Internal Revenue Code § 23 (b). The sole exception is interest connected with the purchase or carrying of certain tax-exempt securities.

²⁹²*Joseph W. Bettendorf*, 3 B. T. A. 378 (1925) (A). But cf. *Longyear v. Helvering*, 77 F. (2d) 116, 64 App. D. C. 238 (1935), holding that interest upon an *alimony* obligation partakes of the nature of the alimony and is not deductible.

²⁹³*Joseph W. Bettendorf*, 3 B. T. A. 378 (1925) (conversion of trust property; since trust relationship is not debt, interest accrued prior to judgment is not deductible); *Harvey M. Toy*, 34 B. T. A. 877 (1936) (NA) (executor's personal liability for estate tax, when he pays other debts without paying tax, held to be a *debt*; interest thereon from time he thus incurred liability, but before judgment, held deductible). Interest, to be deductible, must be upon the taxpayer's own debt, and when the taxpayer becomes responsible for another's liability, the interest accrued prior to the incurring of such liability by the taxpayer is *principal* of the *taxpayer's* debt. *Automatic Sprinkler Co.*, 27 B. T. A. 160 (1932); *Helen B. Sulzberger*, 33 B. T. A. 1093 (1936); *Harvey M. Toy*, 34 B. T. A. 877 (1936).

²⁹⁴*Athol Mfg. Co. v. Comm'r*, 54 F. (2d) 230 (C. C. A. 1st 1931); *Falk Corp. v. Comm'r*, 60 F. (2d) 204 (C. C. A. 7th 1932); *Merchants Bank Bldg. Co. v. Helvering*, 84 F. (2d) 478 (C. C. A. 8th 1936); *Bermont Oil Co. v. Helvering*, 91 F. (2d) 710, 67 App. D. C. 256 (1937); *F. Tinker & Sons Co.*, 1 B. T. A. 799 (1925); *Sigmund*

that where there is not merely a sale of assets but a merger or consolidation of corporations in which "the corporate personality of the transferor is drowned in that of the transferee," with the debts assumed by operation of law (whether or not there is also a contractual assumption), the successor may deduct any loss which the predecessor might have deducted.²⁹⁵ When the taxpayer is given money or its equivalent in consideration of his assumption of liability which is then in litigation or otherwise contingent, the determination of gain or loss to the taxpayer upon the transaction is postponed until it is completed by the termination of the litigation; although cash may have been received at the time of the assumption, it was merely the first step in a transaction entered for profit, which is completed at the conclusion of the litigation.²⁹⁶

There is another kind of loss which litigation may entail, apart from the judgment itself. The question of the deductibility of the loss sustained through the execution sale of the defendant's property does not appear to have arisen

Spitzer, 23 B. T. A. 776 (1931); Caldwell & Co., 26 B. T. A. 790 (1932), *aff'd w.o. op.*, 65 F. (2d) 1012 (C. C. A. 2d 1933); Watab Paper Co., 27 B. T. A. 488, 505 (1932), *appeal dismissed*, 68 F. (2d) 1021 (C. C. A. 8th 1933).

It is immaterial that the liability was in litigation or otherwise contingent at the time of the transfer. *Bermont Oil Co. v. Helvering*, *supra* (taxpayer agreed to hold seller harmless from suits arising from his prior ownership of property; payment in later litigation against seller held not deductible but added to cost as a contingent part of price); *F. Tinker & Sons Co.*, *supra*, at 803; *Caldwell & Co.*, *supra*; *Watab Paper Co.*, *supra* (patent litigation; so far as settlement related to predecessor's infringements, held not deductible).

The person whose obligation was assumed in connection with his disposition of property must include the amount of such obligation in the proceeds of the property, in determining gain or loss, but (even on the cash basis) may deduct the amount paid by the assumer as if it had been paid by the taxpayer himself (if the obligation was of a deductible kind). *Norman Cooledge*, 40 B. T. A. 1324 (1939) (A).

²⁹⁵Although some doubt is cast upon this proposition by the *Athol Mfg. Co.* and *Merchants Bank* cases, *supra* note 294, the conclusion in the text seems to follow from the recent cases of *Helvering v. Metropolitan Edison Co.*, 306 U. S. 522, 59 Sup. Ct. 634 (1939), and *General Gas & Electric Corp. v. Helvering*, 306 U. S. 530, 56 Sup. Ct. 638 (1939), which held that unamortized bond discount, which a debtor may take as a loss upon the premature redemption of bonds, may be so taken by a successor corporation under the circumstances mentioned in the text. A *de facto* merger, not following statutory forms, was held to fall within the rule if in fact the successor becomes liable for the predecessor's obligations by operation of law.

It appears that the mere fact that a transaction falls within the reorganization provisions of Internal Revenue Code § 112 is not material. *Merchants Bank Bldg. Co. v. Helvering*, 84 F. (2d) 478 (C. C. A. 8th 1936). Cf. *American Gas & Electric Co. v. Comm'r*, 85 F. (2d) 527 (C. C. A. 2d 1936). The identity of the old company must be lost in the new one and the liabilities must be assumed by operation of law.

Of course, in the absence of direct authority, one can only speculate upon whether the rule respecting bond discount will be extended to litigation losses.

²⁹⁶*Taylor v. Comm'r*, 89 F. (2d) 465 (C. C. A. 7th 1937), *aff'g* 34 B. T. A. 347 (1936), *cert. denied*, 302 U. S. 727, 58 Sup. Ct. 48 (1937). Cf. *O. B. Barker*, 3 B. T. A. 1180 (1926) (A) (stockholder received liquidating dividend; he was held liable for taxes as transferee in later years; permitted to offset liability against gain in year of dividend; as a leading case for constructive trust theory, *supra* note 184, its present authority is doubtful since that theory seems to be dying).

in the cases. Since it may often occur that property not used in trade or business or held for profit may be sold to satisfy a business judgment, or *vice versa*, the question of the deductibility of such losses is not free from doubt. Upon principle, it would seem that the deductibility of the loss, at least so far as it is traceable to the forced sale and not to depreciation and market decline,²⁹⁷ should depend upon the nature of the transaction from which the judgment results rather than upon the purpose for which the property was held; for the loss, to that extent, was proximately caused by the judgment.²⁹⁸

e. *Adverse judgments: when deductible*

Assuming that the taxpayer's liability upon a particular cause of action would be deductible, at what time may the deduction be taken? A great volume of litigation has concerned this problem, since the tax saved by the deduction may be greater if the loss or expense is taken in a year in which the tax rates are higher, or when the taxpayer's income is in the higher brackets, and the benefit of the deduction may be lost if it is allocated to a year in which he has no net income against which to offset it.

When the taxpayer makes his return upon the cash receipts and disbursements basis, it is, of course, clear that no deduction may be taken for a disputed claim which is not adjudicated and paid until a later year.²⁹⁹ For it is necessary that *payment* be made in cash or its equivalent. The taxpayer's note is not the equivalent of cash,³⁰⁰ and a deduction may not be taken when

The question involved in this footnote and the related text concerns the gain or loss realized upon the *receipt* of money or property in liquidation or in a taxable exchange; it is distinct from the question in the two preceding footnotes and related text, namely, whether the payment or accrual of the *liability* can give rise to a loss deduction while property received in consideration of its assumption is still held.

²⁹⁷Cf. *Helvering v. Owens*, 305 U. S. 468, 59 Sup. Ct. 260 (1939), relating to the *casualty* loss of non-business property. To segregate the casualty loss from the non-deductible personal loss, the Court used as the basis the market value at the date of the casualty (thus excluding prior depreciation and market decline from consideration).

²⁹⁸The loss to be so treated would be determined, under this formula, by deducting from the market price at the time of execution sale (the basis, *supra* note 297), the amount realized and applied upon the judgment. The judgment loss would be separately treated.

By analogy to the cases on mortgage foreclosures, *supra* note 250, the Board and the Sixth Circuit would probably hold it an *ordinary* loss if the property was sold under execution, a *capital* loss if *voluntarily* transferred in full or partial satisfaction of the obligation; the Bureau and the Second Circuit would hold it a capital loss in either case, if the property so sold is within the definition of a "capital asset" [Internal Revenue Code § 117 (a) (1)].

²⁹⁹*Fidelity Title & Trust Co. v. Heiner*, 34 F. (2d) 350 (W. D. Pa. 1929); *Frank L. Orth*, 9 B. T. A. 249 (1927) (A).

³⁰⁰*Eckert v. Burnet*, 283 U. S. 140, 51 Sup. Ct. 373 (1931); *Helvering v. Price*, 309 U. S. 409, 60 Sup. Ct. 673 (1940); *Hart v. Comm'r*, 54 F. (2d) 848 (C. C. A. 1st 1932); *S. E. Thomaston*, 33 B. T. A. 576 (1935), *appeal dismissed*, 90 F. (2d) 1019 (C. C. A. 7th 1937); *Frank Kuhn*, 34 B. T. A. 274 (1936); *T. Harvey Ferris*, 38 B. T. A. 312 (1938), *aff'd w.o. op.*, 102 F. (2d) 985 (C. C. A. 2d 1939).

the taxpayer gives the claimant his note,³⁰¹ even though it may be that the judgment or other liability is legally discharged by the act and a new liability, with different incidents, is created.³⁰² The giving of collateral is not payment, for the collateral remains the taxpayer's property and merely secures payment at a *later* time.³⁰³ On the other hand, it was held that payment with money borrowed from a *third party* permits a deduction.³⁰⁴ The Board has held that the taking over of one's assets by a bankruptcy trustee constitutes payment at that time, just as if it were a composition with creditors.³⁰⁵

When the accrual basis is used, the deduction is taken in the year in which occur all the events which fix the amount and determine the liability to pay it.³⁰⁶ Nevertheless, it is not necessary that the exact amount of liability upon a cause of action be fixed if there is a definite *admission* of liability, negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued upon the books.³⁰⁷ Accrual upon the books, alone, is not enough, in the absence of a communicated admission of liability.³⁰⁸ A mere offer of settlement, without an admission of liability, also is

³⁰¹The note, if negotiable and marketable, is income to the *plaintiff* on the cash basis, to the extent of its fair market value. See Part One, note 111. But the *defendant* has parted with nothing.

³⁰²It has at last been settled that a mere change in the nature of a liability to the same creditor, as from secondary liability to primary, is not a payment for income tax purposes, no matter what forms are adopted to discharge the old obligation and create a new one. *Helvering v. Price*, 309 U. S. 409, 60 Sup. Ct. 673 (1940), *rev'd* 106 F. (2d) 336 (C. C. A. 4th 1939). See cases cited *supra* note 300. *Cf. contra*: *Jenkins v. Smith*, 21 F. Supp. 433 (D. Conn. 1937), *rev'd on other grounds*, 99 F. (2d) 827 (C. C. A. 2d 1938).

³⁰³*Helvering v. Price*, 309 U. S. 409, 60 Sup. Ct. 673 (1940); *Frank Kuhn*, 34 B. T. A. 274 (1936). *Cf. Insurance Finance Co. v. Comm'r*, 84 F. (2d) 382 (C. C. A. 3d 1936) (collateral deposited with surety on appeal bond; no deduction until surety sold collateral and paid judgment).

³⁰⁴*Crain v. Comm'r*, 75 F. (2d) 962 (C. C. A. 8th 1935); *Humphrey v. Comm'r*, 91 F. (2d) 155 (C. C. A. 9th 1937); *Robert B. Keenan*, 20 B. T. A. 498 (1930). *But cf. Quinn v. Comm'r*, 111 F. (2d) 372 (C. C. A. 5th 1940).

³⁰⁵*Charles R. Stuart*, 38 B. T. A. 1147 (1938). The amount of the deduction, of course, is the proportion of his net assets which will be applied to the deductible liability.

³⁰⁶*United States v. Anderson*, 269 U. S. 422, 441, 46 Sup. Ct. 131 (1926).

³⁰⁷*See Lucas v. American Code Co.*, 280 U. S. 445, 450, 50 Sup. Ct. 202, 67 A. L. R. 1010 (1930), approving a long line of Board of Tax Appeals cases. *Landers Bros. Co. v. Comm'r*, 60 F. (2d) 85 (C. C. A. 6th 1932); *Producers Fuel Co.*, 1 B. T. A. 202 (1924) (A) (deliberate breach of contract, for which taxpayer recognized liability and began negotiating settlement; estimated liability on books); *Raleigh Smokeless Fuel Co.*, 6 B. T. A. 381 (1927) (A) (same facts, but other party sued in next year; taxpayer, however, did not defend); *Beacon Coal Co.*, 9 B. T. A. 280 (1927) (A); *Fraser Brick Co.*, 10 B. T. A. 1252 (1928) (A). *Cf. Baltimore & Ohio R. R. v. Comm'r*, 78 F. (2d) 456 (C. C. A. 4th 1935); *Anderson-Clayton Securities Corp.*, 35 B. T. A. 795, 802 (1937).

³⁰⁸*Ledbetter Mfg. Co.*, 12 B. T. A. 145 (1928). *But see H. Northwood & Co.*, 4 B. T. A. 697, 703 (1926) (A) (taxpayer accrued liability on books and deducted expense, but resisted suit therefor; case contains statements implying that the accrual was proper at that time, but the only holding is that he may not shift the deduction to the year judgment was entered against him, since he appealed; it would seem that the proper time is the date of final affirmance, and that accrual on the books is immaterial in such circumstances). With respect to reserves, see *infra* note 328.

not sufficient.³⁰⁹ If accrual is properly made at the time of the admission of liability, then when the actual amount of the liability is finally determined, the return for the year in which the liability accrued is corrected accordingly; no adjustment should be reflected in the return for the year in which the amount was agreed upon.³¹⁰

However, if the taxpayer does not *admit* liability for the breach of contract or other injury, even if suit is commenced therefor, no deduction may then be taken.³¹¹ Such a liability, which for many reasons may never have to be paid, is considered too contingent to accrue.³¹² The taxpayer will be denied a deduction in the year in which the cause of action arose, even though he realizes that he is liable, if he fails to communicate to the other party his willingness to make reparation,³¹³ but it seems that when the

³⁰⁹New Process Cork Co., 3 B. T. A. 1339 (1926); Standard Brewing Co., 6 B. T. A. 980 (1927); Lynchburg Colliery Co., 7 B. T. A. 282 (1927).

³¹⁰Producers Fuel Co., 1 B. T. A. 202 (1924) (A); Beacon Coal Co., 9 B. T. A. 280 (1927) (A); Fraser Brick Co., 10 B. T. A. 1252 (1928) (A).

³¹¹Lucas v. American Code Co., 280 U. S. 445, 50 Sup. Ct. 202, 67 A. L. R. 1010 (1930); Daniels & Fisher Stores Co. v. United States, 56 F. (2d) 477, 74 Ct. Cl. 233 (1932); J. N. Pharr & Sons v. Comm'r, 56 F. (2d) 832 (C. C. A. 5th 1932); Clark Dredging Co. v. Comm'r, 63 F. (2d) 527 (C. C. A. 5th 1933), *aff'd* 23 B. T. A. 503 (1931); P. C. Tomson & Co. v. Comm'r, 82 F. (2d) 398 (C. C. A. 3d 1935); Schwartz v. United States, 84 F. (2d) 637 (C. C. A. 5th 1936); Crown Cork & Seal Co. v. United States, 4 F. Supp. 525 (E. D. N. Y. 1933), *aff'd w.o. op.*, 73 F. (2d) 997 (C. C. A. 2d 1934); Brighton Mills, 1 B. T. A. 392 (1935); New Process Cork Co., 3 B. T. A. 1339 (1926); Bump Confectionery Co., 4 B. T. A. 50 (1926); Louis Kratter, 4 B. T. A. 52 (1926); Hamler Coal Co., 4 B. T. A. 947 (1926); Lane Construction Co., 4 B. T. A. 1133 (1926); Empire Printing & Box Co., 5 B. T. A. 203 (1926); Humble & Gulf Coast Oil Co., 5 B. T. A. 328 (1926); Nice Ball Bearing Co., 5 B. T. A. 484 (1926); Gopher Granite Co., 5 B. T. A. 1216 (1927); Lynchburg Colliery Co., 7 B. T. A. 282 (1927); Hidalgo Steel Co., 8 B. T. A. 76 (1927); Ledbetter Mfg. Co., 12 B. T. A. 145 (1928); Thorne, Neal & Co., Inc., 13 B. T. A. 490 (1928) (NA); Lehigh & Hudson River Ry., 13 B. T. A. 1154 (1928), *aff'd on this point*, 38 F. (2d) 1015 (C. C. A. 2d 1930), *cert. denied*, 281 U. S. 748, 50 Sup. Ct. 353 (1930); J. G. Curtis Leather Co., 13 B. T. A. 1259 (1928) (NA); Lane Construction Co., 17 B. T. A. 826 (1929), *aff'd w.o. op.*, 49 F. (2d) 1080 (C. C. A. 2d 1931); Sunset Color Works, 21 B. T. A. 304 (1930); Estate of Wilton J. Lambert, 40 B. T. A. 801, 809 (1939) (liabilities which were disputed at time of death may not be deducted from decedent's income); I. T. 2843, XIV-1 Cum. BULL. 77 (1935).

A mere offer of settlement without an admission of liability is not sufficient. *Supra* note 309. Even the deposit in court of a sum as an offer of compromise is not sufficient to permit an accrual until the offer is accepted, for it may be rejected and the litigation continue. Standard Brewing Co., 6 B. T. A. 980 (1927).

The fact that the disputed property is already in the possession of the claimant, on loan or trust, does not give rise to a deduction prior to a settlement and relinquishment of the taxpayer's interest. Davidson v. Comm'r, 91 F. (2d) 516 (C. C. A. 5th 1937), *aff'd* 34 B. T. A. 479 (1936).

³¹²See Lucas v. American Code Co., 280 U. S. 445, 450-451, 50 Sup. Ct. 202 (1930).

³¹³Bump Confectionery Co., 4 B. T. A. 50 (1926) (clear breach of contract but *no admission* of liability; negotiations failed, leading to suit in next year; deduction denied in year of breach); Louis Kratter, 4 B. T. A. 52 (1926); Hamler Coal Co., 4 B. T. A. 947 (1926) (taxpayer realized he was liable for breach but Board requires recognition of liability *communicated* to the other, and an estimate entered upon the books); Empire Printing & Box Co., 5 B. T. A. 203 (1926) (clear breach, but taxpayer threatened to

taxpayer rather than the Commissioner is seeking to postpone the deduction to a year later than that in which the claim arose, he must show that he disputed liability in good faith and upon reasonable grounds, for otherwise he could use flimsy pretexts to shift a deduction to the year in which he could use it to best advantage.³¹⁴ The cases are not entirely clear respecting the time of accrual when *liability* is admitted but the *amount* thereof is not; it seems that when the amount of the liability can reasonably be estimated from existing facts and the parties are amicably negotiating to liquidate it, accrual is not postponed,³¹⁵ but if the amount is in litigation, an element of contingency is introduced which prevents accrual until final determination.³¹⁶

When a deduction is not permitted in the year in which the cause of action arose, because of the taxpayer's failure to admit liability, it is taken, on the accrual basis, when liability is finally determined by settlement or judgment.³¹⁷ A judgment of a lower court does not give rise to a deduction if an appeal is taken,³¹⁸ for liability is still contingent as long as the litigation

stand suit rather than pay; no deduction allowable at that time); J. G. Curtis Leather Co., 13 B. T. A. 1259 (1928); Sunset Color Works, 21 B. T. A. 304 (1930).

³¹⁴McCabe Lathe & Machinery Co., 9 B. T. A. 1137 (1928) (liability contested, but evidence before Board showed no sound reason for contest; taxpayer's attempt to postpone deduction to date of settlement denied); Thorne, Neal & Co., Inc., 13 B. T. A. 490 (1928) (NA) (dispute in good faith and upon reasonable grounds held sufficient to permit taxpayer to postpone deduction).

³¹⁵*Supra* note 307. See *Helvering v. St. Louis Southwestern Ry.*, 66 F. (2d) 633, 634 (C. C. A. 8th 1933).

³¹⁶*Central Trust Co. v. Burnet*, 45 F. (2d) 922, 60 App. D. C. 4 (1930) (liability for fraud determined by court, but auditor's accounting not made final until much later; held, deduction may not be taken until decree is final and litigation is closed); *cf. J. N. Pharr & Sons v. Comm'r*, 56 F. (2d) 832 (C. C. A. 5th 1932) (litigation concerned basis for determining damages; however, it appears from the report in 21 B. T. A. 245 (1930) that *liability* was also in dispute).

³¹⁷Regulations 103, sec. 19.43-2. See notes (1928) 55 A. L. R. 1283, (1939) 121 A. L. R. 715.

Cf. N. Sobel, Inc., 40 B. T. A. 1262 (1939) (NA), in which taxpayer bought bank stock in 1929, giving his note to the bank; in 1930, taxpayer defended a suit upon the note and asked rescission, claiming the transaction was illegal; stock became worthless in 1930; settled suit in 1935; held, loss should be taken, not in 1930 when stock became worthless, but in 1935, because until that time it was uncertain that the taxpayer would suffer any loss from the worthlessness of the stock.

³¹⁸*Consolidated Tea Co. v. Bowers*, 19 F. (2d) 382 (S. D. N. Y. 1927); *Columbus Plate & Window Glass Co. v. Miller*, 38 F. (2d) 509 (S. D. Ohio 1930) (judgment affirmed on appeal not deductible when application for *certiorari* had been made to United States Supreme Court and not acted upon); *Malleable Iron Range Co. v. United States*, 62 Ct. Cl. 425 (1926); *H. Northwood & Co.*, 4 B. T. A. 697 (1926); *Farmers Nat'l Bank, Exec'r*, 6 B. T. A. 1036 (1927); *Frank J. Jewell*, 6 B. T. A. 1040 (1927); *Lehigh & Hudson River Ry.*, 13 B. T. A. 1154 (1928), *aff'd on this point*, 38 F. (2d) 1015 (C. C. A. 2d 1930), *cert. denied*, 281 U. S. 748, 50 Sup. Ct. 353 (1930).

If the taxpayer does not plan to appeal, no case has passed upon the question whether he may deduct at once or must wait until time to appeal expires. *Cf. H. Liebes & Co. v. Comm'r*, 90 F. (2d) 932, 938 (C. C. A. 9th 1937) (*income* accrues to plaintiff only at expiration of time to appeal). A definite *acknowledgment* of liability would probably permit accrual before expiration of time to appeal.

An award of back wages by the National Labor Relations Board, from which no

continues.³¹⁹ A settlement agreement gives rise to a deduction although it may be discharged and the litigation reinstated by the taxpayer's failure to perform.³²⁰ But when a settlement made by or for a minor requires court approval before it is binding, no deduction may be taken until the settlement is made final by such approval.³²¹ The deduction of a disputed liability may never be related back to a prior year, either to offset prior income which by the judgment or settlement is turned over to the plaintiff,³²² or to allocate expenses to the years in which benefits were enjoyed,³²³ or to increase the cost of goods sold, to which the disputed liability related.³²⁴

It has been held, however, that, at least on the accrual basis, a deposit in escrow to stay execution pending appeal is sufficient to permit a deduction at that time.³²⁵ A mere deposit of collateral to protect one's own surety is not sufficient, however.³²⁶ Attachment or garnishment of one's property does

appeal is taken, gives rise to a deduction at the time of the decision. I. T. 3412, (Sept. 23, 1940) I. R. BULL. No. 39, p. 5.

An interlocutory judgment or other non-final action of the court does not justify accruing a deduction. *Central Trust Co. v. Burnet*, 45 F. (2d) 922, 60 App. D. C. 4 (1930).
³¹⁹S. R. 5498, IV-2 CUM. BULL. 154 (1925). See *supra* note 312.

³²⁰*Cf. Helvering v. Russian Finance & Constr. Corp.*, 77 F. (2d) 324 (C. C. A. 2d 1935) (condition subsequent does not prevent accrual of expense); *Estate of G. A. E. Kohler*, 37 B. T. A. 1019 (1938) (A). But *cf. Walker v. Comm'r*, 88 F. (2d) 170 (C. C. A. 5th 1937), cert. denied, 302 U. S. 692, 58 Sup. Ct. 11 (1937) (performance construed to be condition precedent).

³²¹*Cf. Mary D. Moore Holifield*, 7 B. T. A. 1302 (1927).

³²²*Trippensee Mfg. Co.*, 15 B. T. A. 15 (1929) (NA) (overcharges returned after parties agreed upon different interpretation of contract); *Arabol Mfg. Co.*, 26 B. T. A. 1068 (1932) (NA); *Frederick S. Buggie*, 32 B. T. A. 581 (1935) (settlement of title suit may not be related back to reduce profit on the property, which has meanwhile been sold). See Part 2 (a), *supra*.

³²³*John R. Lankenau Co. v. United States*, 46 F. (2d) 158 (D. Mass. 1930) (suit for salary of employee; judgment may not be spread over years in which services rendered); *Safe Guard Check Writer Corp.*, 10 B. T. A. 1262 (1928) (A) (settlement of patent suit may not be spread over years of infringement). But see *Maney Milling Co.*, 14 B. T. A. 1001 (1929) (Commissioner voluntarily spread settlement, and Board was "not inclined to disturb" his action).

³²⁴*Price Iron & Steel Co. v. Burnet*, 45 F. (2d) 921, 60 App. D. C. 3 (1930) (scrap purchased from Director General of Railroads; subsequently, additional price was claimed because of erroneous classification; settlement may not be related back as added cost of goods sold); *Lucas v. Providence Coal Mining Co.*, 60 F. (2d) 86 (C. C. A. 6th 1932) (taxpayer wrongfully mined coal under adjoining land; subsequent settlement may not be related back as cost of coal removed and sold); *Providence Coal Mining Co.*, 5 B. T. A. 1179 (1927) (same).

³²⁵*Becker Bros. v. United States*, 7 F. (2d) 3 (C. C. A. 2d 1925) (escrow deposit pending appeal held deductible when made, but at the amount to which it was reduced on appeal; accounting basis not stated); *Malleable Iron Range Co. v. United States*, 65 Ct. Cl. 441 (1928) (accrual basis). *Cf. contra*, on cash basis: *Insurance Finance Corp. v. Comm'r*, 84 F. (2d) 382 (C. C. A. 3d 1936) (to get appeal bond, purchased and deposited securities with surety; no deduction until, after affirmation, surety sold collateral and paid judgment).

On the other hand, no deduction may be accrued when one makes a deposit as an offer in compromise, until it is accepted. *Standard Brewing Co.*, 6 B. T. A. 980 (1927).

³²⁶*Clark Dredging Co.*, 23 B. T. A. 503 (1931), *aff'd*, 63 F. (2d) 527 (C. C. A. 5th

not give rise to a deduction prior to the close of the litigation.³²⁷ Of course, even though good accounting practice may dictate the setting up of a reserve to provide against the probable loss of a lawsuit, payments into such reserves may not be deducted.³²⁸

When the taxpayer is on the completed contract basis,³²⁹ it has been declared by the Board that a contract should be held open and no gain or loss reported thereon until a lawsuit against the taxpayer, growing out of the contract, has been concluded, since the ultimate gain or loss from the contract cannot be determined until that time.³³⁰ The Court of Claims, on the other hand, has held that the contract may not thus be held open after the work is completed and paid for.³³¹

Although the principles above stated apply to private causes of action against the taxpayer, they are not applied to liabilities to a government for taxes or fees. It is denied that such liabilities are rendered contingent merely because the taxpayer disputes them, and their accrual is *not* postponed by

1933) (accrual basis); Insurance Finance Corp. v. Comm'r, 84 F. (2d) 382 (C. C. A. 3d 1936) (cash basis).

³²⁷Arthur A. Cocke, 5 B. T. A. 606 (1926).

³²⁸Lucas v. American Code Co., 280 U. S. 445, 50 Sup. Ct. 202 (1930); Consolidated Tea Co. v. Bowers, 19 F. (2d) 382 (S. D. N. Y. 1927); Bump Confectionery Co., 4 B. T. A. 50 (1926); Hidalgo Steel Co., 8 B. T. A. 76 (1927); Maney Milling Co., 14 B. T. A. 1001 (1929); Leo Oppenheimer, 16 B. T. A. 993 (1929) (segregated bank account as reserve); Lane Construction Co., 17 B. T. A. 826 (1929), *aff'd w.o. op.*, 49 F. (2d) 1080 (C. C. A. 2d 1931) (expert testimony that reserve is good accounting, held immaterial); Monroe Abstract Corp., 41 B. T. A. 5 (1940) (contract with insurer of taxpayer's title searches required setting up reserve against liability). Cf. Brown v. Heilvering, 291 U. S. 193, 199, 54 Sup. Ct. 356 (1934); Comm'r v. Alamitos Land Co., 112 F. (2d) 648, 651 (C. C. A. 9th 1940), *cert. denied*, 61 Sup. Ct. 46 (1940). Of course, when an expense has *accrued* (i.e., undisputed) it is deductible even though the accrued expense account is mislabeled a "reserve." Anderson-Clayton Securities Corp., 35 B. T. A. 795, 802 (1937) (A).

Although when accrued expenses are ultimately not paid they are taken back into income [*infra* Part 2 (f)], no income is realized when a reserve for litigation is eliminated from the books, since no deduction was allowable when the reserve was set up. Peabody Coal Co., 18 B. T. A. 1081, 1091 (1930) (A), *aff'd on other grounds*, 55 F. (2d) 7 (C. C. A. 7th 1931), *cert. denied*, 287 U. S. 605, 53 Sup. Ct. 9 (1932); G. M. Standifer Constr. Co., 30 B. T. A. 184 (1934) (A), *aff'd on other grounds*, 78 F. (2d) 285 (C. C. A. 9th 1935).

³²⁹Regulations 103, sec. 19.42-4. See Part One, (Feb. 1940) 25 CORNELL L. Q. 221, 246.

³³⁰See Carolina Contracting Co., 32 B. T. A. 1171, 1176 (1935) (A). However, if the taxpayer *does* close his books on the contract and report the income when work is completed and paid for, he may not include in the computation any deduction for liabilities then in litigation. Cf. National Contracting Co. v. Comm'r, 105 F. (2d) 488, 495 (C. C. A. 8th 1939) (relating to liabilities to the taxpayer; the same principle would apply to a defendant-taxpayer).

³³¹Cf. Grays Harbor Motorship Corp., 45 F. (2d) 259, 280, 71 Ct. Cl. 167, 211-212 (1930), *cert. denied*, 284 U. S. 627, 52 Sup. Ct. 11 (1931) (relating to liabilities to the taxpayer). This case seems more consistent with the regulations, which require reporting the net profit when the contract is "finally completed and accepted." Regulations 103, sec. 19.42-4.

a dispute or litigation.³³² If the taxpayer later settles for a less amount, it has been held that income should *then* be reported to the extent of the saving rather than making an adjustment in the prior accrual of the tax;³³³ the better view, however, seems to be that, so long as the tax liability for the year of accrual has not been conclusively determined, adjustment should be made in that year's return rather than in the return for the year of settlement.³³⁴

The principles previously stated likewise do not apply to a beneficiary's reimbursement of a trust for prior erroneous distributions. Because of the rule that the beneficiary is taxable in the first instance only upon such income as a subsequent court decree holds was properly *distributable* to him,³³⁵ the reimbursement must be dealt with by an adjustment in the return for the year of the erroneous distribution rather than deducted at the time of the judgment or repayment.³³⁶

Since a surety, guarantor, or indorser, in the normal case, takes a bad debt deduction rather than a loss,³³⁷ different principles apply to their liabilities than to others. On the one hand, even though the taxpayer may make payment or lose a judgment, he may not take a deduction until he ascertains

³³²*Russell-Miller Milling Co. v. Helvering*, 69 F. (2d) 392, 63 App. D. C. 74 (1934) (taxpayer was assessed foreign income taxes; he denied liability but finally settled for less; accrual may not be postponed to settlement); *Continental Baking Corp. v. Helvering*, 77 F. (2d) 119, 64 App. D. C. 242 (1935) (taxpayer claimed exemption from capital stock tax because not doing business; paid when Commissioner disallowed claim; dispute does not postpone accrual); *Bartles-Scott Oil Co.*, 2 B. T. A. 16 (1925) (oil inspection fee; refrained from payment pending test case on validity; accrual not postponed); *Brooklyn Union Gas Co.*, 22 B. T. A. 507, 527 (1931), *aff'd on other grounds*, 62 F. (2d) 505 (C. C. A. 2d 1933) (contest of valuation for property tax); *Hygienic Products Co.*, 37 B. T. A. 202, 207 (1938), *aff'd*, 111 F. (2d) 330 (C. C. A. 6th 1940) (like *Russell-Miller* case); *Cartex Mills, Inc.*, 42 B. T. A. No. 130 (1940) (unconstitutional A.A.A. taxes, if not refunded, deductible when incurred).

But see Commissioner's letter of November 1, 1939 [1940 Prentice-Hall ¶ 66039], subsequently rescinded pending reconsideration [1940 Prentice-Hall ¶ 66123], ruling that an intangible property tax for prior years accrued when liability therefor was compromised following a Supreme Court decision in a test case.

³³³*Comm'r v. Central United Nat'l Bank*, 99 F. (2d) 568 (C. C. A. 6th 1938), *aff'g* 33 B. T. A. 588 (1935) (NA).

³³⁴*Joseph V. Horn*, 23 B. T. A. 1131 (1931); *Elsie S. Eckstein*, 41 B. T. A. 746 (1940) (involving settlement of property taxes covering two years; the saving for one year, income tax liability for which was still open, was applied as a correction in the year of accrual; the saving for another year, with respect to which the statute of limitations had passed, was treated as income of the year of settlement). The *Central United Bank* case, *supra* note 333, is inconsistent (although perhaps distinguishable on its facts), since liability for the year of accrual was before the court but was not adjusted. The rule stated in the text follows from the rule respecting *refunds* of taxes. See Part One, (Feb. 1940) 25 CORNELL L. Q. 221, 231-233.

³³⁵See *supra* notes 189-191.

³³⁶*Mary V. Pyle*, 16 B. T. A. 218 (1929); *Margnerite Hyde Suffolk & Berks*, 40 B. T. A. 1120 (1939) (A).

³³⁷*Supra* note 257.

that his right of reimbursement is worthless and charges it off his books.³³⁸ On the other hand, although the principal debtor may be insolvent, the person secondarily liable may not make a charge-off until there exists a *debt* to be charged off;³³⁹ it has been held that, even on the accrual basis, no debt exists from the principal to the person secondarily liable until he has made actual payment, and the mere recovery of judgment against a surety for an insolvent principal gives rise to no deduction.³⁴⁰ In those cases where a guarantor or indemnitor gets no right of reimbursement, so that he deducts a loss rather than a bad debt, the time for making the deduction is the same as for other liabilities.³⁴¹

Special considerations also affect the deduction of a defendant's loss through foreclosure.³⁴² When a mortgage or similar lien is foreclosed, state laws frequently give a period within which the property may be redeemed. It is now settled that, irrespective of technical questions of who has title during that period, the mortgagor has sufficient interest in the property so that there is no "completed transaction" divesting him of his interest and establishing the loss. The loss may not be deducted until the redemption period expires.³⁴³ When the mortgagor contests the validity of the foreclosure sale, so that there is a possibility that he may not yet lose the property, the loss is held to be deductible when it becomes final through the settlement or other con-

³³⁸Milton H. Bickley, 1 B. T. A. 544 (1925) (A); Lena G. Hill, 8 B. T. A. 1159 (1927) (A); Haxton v. United States, 30 F. Supp. 506 (W. D. N. Y. 1939).

³³⁹H. Rodney Sharp, 38 B. T. A. 166 (1938) (A) (principal known to be insolvent long before taxpayer-guarantor made payment; deductible when paid and charged off); A. R. 479, 5 CUM. BULL. 146 (1921) (similar); and cases cited in the next footnote.

³⁴⁰*Accrual basis*: J. P. Badenhausen, 7 B. T. A. 910 (1927), disapproved in M. A. Burns Mfg. Co. v. Comm'r, 59 F. (2d) 504, 507 (C. C. A. 9th 1932). *But cf.* Fraser Brick Co., 10 B. T. A. 1252 (1928) (A) (guarantor for insolvent contractor admitted and accrued liability; held deductible prior to payment).

Cash basis: The giving of a new note assuming primary liability, although the old note is discharged thereby and is legally regarded as "paid", is not sufficient. Eckert v. Burnet, 283 U. S. 140, 51 Sup. Ct. 373 (1931); Helvering v. Price, 309 U. S. 409, 60 Sup. Ct. 673 (1940), *rev'g* Price v. Comm'r, 106 F. (2d) 336 (C. C. A. 4th 1939); Frank Kuhn, 34 B. T. A. 274 (1936); T. Harvey Ferris, 38 B. T. A. 312 (1938), *aff'd w.o. op.*, 102 F. (2d) 985 (C. C. A. 2d 1939). But it has been held that payment with money borrowed from a third party is sufficient. Crain v. Comm'r, 75 F. (2d) 962 (C. C. A. 8th 1935). Giving collateral does not constitute payment. Helvering v. Price, *supra*; Frank Kuhn, *supra*.

³⁴¹Yoder v. Nauts, 34 F. (2d) 450 (N. D. Ohio 1928) (accrue when liquidated); Schwartz v. United States, 84 F. (2d) 637 (C. C. A. 5th 1936) (bail bondsman not allowed to deduct liabilities which had only reached preliminary stage and had not been admitted).

³⁴²See Paul, *Federal Income Tax Problems of Mortgages and Mortgagees* (1939) 48 YALE L. J. 1315, 1318-1322, for the historical development of the rules herein stated.

³⁴³J. C. Hawkins, 34 B. T. A. 918 (1936) (A), *aff'd*, 91 F. (2d) 354 (C. C. A. 5th 1937); Derby Realty Corp., 35 B. T. A. 335 (1937) (A), *appeal dismissed*, 92 F. (2d) 999 (C. C. A. 6th 1937); Shelden Land Co., 42 B. T. A. 498 (1940) (A); *see* Nickoll v. Comm'r, 103 F. (2d) 619, 621 (C. C. A. 7th 1939). The Bureau at first took a contrary view. G. C. M. 12737, XIII-1 CUM. BULL. 120 (1934); G. C. M. 12860, XIII-1 CUM.

clusion of the dispute.³⁴⁴ However, it has been held that even the mere commencement of foreclosure proceedings may be sufficient, when added to other factors, to show complete and permanent *worthlessness* giving rise to a deduction before the foreclosure is completed.³⁴⁵ If the *mortgagor* himself buys the property on foreclosure, no loss may be deducted since it is, in effect, a sale to himself;³⁴⁶ but where one or more, but less than all, of joint mortgagors purchase at a foreclosure sale, it has been held that the old transaction is closed and a new transaction, with fewer joint owners, is entered, so that a loss is realized upon the prior transaction.³⁴⁷

The mere adjudication that one's title to property is defective does not give rise to a deductible loss prior to the disposition of the property.^{347a}

When a defendant faced with the threat of execution upon his property conveys it to another on a secret trust, the Board has held that there is no completed gift, for income tax purposes, and that the taxpayer may still realize a loss upon the subsequent disposition of the property, at least if by

BULL. 123 (1934); G. C. M. 13360, XIII-2 CUM. BULL. 194 (1934). But the rule herein stated is now accepted. G. C. M. 19367, 1937-2 CUM. BULL. 115.

The same rule applies to tax sales. Frederick Krauss, 30 B. T. A. 62 (1934); T. J. Bosquett, 39 B. T. A. 763 (1939); I. T. 2711, XII-2 CUM. BULL. 51 (1933); G. C. M. 15669, XIV-2 CUM. BULL. 154 (1935). Cf. Nebraska Bridge Supply & Lumber Co., 40 B. T. A. 40 (1939) (NA), in which filing of certificate by clerk was required in order to pass title finally to state; filing was delayed until year after redemption period expired; although an ambiguous and unconstrued statute left some doubt whether taxpayer could redeem after period expired but before filing, an attempt to do so would have entailed a lawsuit; held, therefore, that loss may be deducted when redemption period expired, not postponed until certificate was filed.

³⁴⁴Morton v. Comm'r, 104 F. (2d) 534 (C. C. A. 4th 1939). The loss was held to be contingent as long as there was a possibility that the court would invalidate the sale and the taxpayer regain the property.

³⁴⁵Rhodes v. Comm'r, 100 F. (2d) 966 (C. C. A. 6th 1939); W. W. Hoffman, 40 B. T. A. 459 (1939) (NA), on appeal, C. C. A. 2d; Realty Operators, Inc., 40 B. T. A. 1050 (1939) (NA). Cf. Shoolman v. Comm'r, 108 F. (2d) 987 (C. C. A. 1st 1940), *cert. denied*, 310 U. S. 637, 60 Sup. Ct. 1080 (1940) (no abandonment found). The cases cited, and those distinguished therein, should be consulted to determine what fact situations are or are not deemed sufficient to permit a deduction while an interest in property is still retained. The Bureau does not accept the rule of the cases cited.

Cf. Morris Polin, 39 B. T. A. 951 (1939) (NA), *rev'd on other grounds*, 114 F. (2d) 174 (C. C. A. 3d 1940) (loss sustained when surrendered property to mortgagee, although mortgagee then proceeded to foreclose).

³⁴⁶See Tompkins v. Comm'r, 97 F. (2d) 396, 401 (C. C. A. 4th 1938); H. L. Rust, Jr., 38 B. T. A. 910, 912 (1938) (NA), *appeal dismissed*, 105 F. (2d) 1017 (C. C. A. 4th 1939); Ferdinand Hotz, 42 B. T. A. 432 (1940).

³⁴⁷Tompkins v. Comm'r, 97 F. (2d) 396 (C. C. A. 4th 1938); H. L. Rust, Jr., 38 B. T. A. 910 (1938) (NA), *appeal dismissed*, 105 F. (2d) 1017 (C. C. A. 4th 1939). The condition is imposed that the transaction must be *bona fide* and with no taint of motives of tax avoidance.

But cf. Ferdinand Hotz, 42 B. T. A. 432 (1940) (joint mortgagor, acting alone, redeemed before expiration of trust period; held, no loss sustained).

^{347a}George C. Beidleman, 7 B. T. A. 899 (1927). Cf. Davenport v. United States, 34 F. Supp. 290 (S. D. W. Va. 1940) (taxpayer relinquished a clearly severable portion of certain property in compromise of a dispute over his title to the whole; loss of its value allowed).

local law his equitable interest may be proved by parol against a stranger (the Commissioner).³⁴⁸

f. *Claims settled or not paid*

If the defendant settles for less than the amount demanded, or does not pay a claim because his defense is successful or because the other party fails to sue or fails to collect a judgment, is income realized to the extent of the amount saved?³⁴⁹ The answer depends less upon the merits of his defense than upon whether the defendant has received benefits which have not been previously taxed. If the claim is for a matter in the nature of an *expense* which the defendant has never deducted, either because he is on the cash basis or because accrual was prevented by the existence of the dispute or because it was not deductible, *no* income is realized when he fails to pay or settles for a smaller sum than had been demanded.³⁵⁰

If, on the other hand, the taxpayer has properly deducted expenses or has obtained assets, and the obligation is subsequently settled for a smaller amount, income is realized.³⁵¹ The courts have developed exceptions to that rule, however, and hold that no income is realized in such a case if the defendant is then insolvent so that the settlement actually makes no assets available to him, freed from the claims of creditors,³⁵² or if the entire trans-

³⁴⁸Park Chamberlain, 41 B. T. A. 10 (1940) (NA), on appeal, C. C. A. 7th.

³⁴⁹See full discussion in Darrell, *Discharge of Indebtedness and the Federal Income Tax* (April 1940) 53 HARV. L. REV. 977.

³⁵⁰Peabody Coal Co., 18 B. T. A. 1081, 1091 (1930) (A), *aff'd on other grounds*, 55 F. (2d) 7 (C. C. A. 7th 1931), *cert. denied*, 287 U. S. 605, 53 Sup. Ct. 9 (1932) (reserve set up for lawsuits which failed to materialize); G. M. Standifer Construction Co., 30 B. T. A. 184 (1934) (A), *aff'd on other grounds*, 78 F. (2d) 285 (C. C. A. 9th 1935) (balance left in litigation reserve after settlement); N. Sobel, Inc., 40 B. T. A. 1262 (1939) (NA) (taxpayer gave note for stock, later sued to rescind; settled by paying half price; stock meanwhile had become worthless; since Board held no loss was deductible upon stock until settlement, because of contingency, taxpayer had had no benefit of a deduction and had no asset left, so no income was realized by settlement). Cf. Comm'r v. Rail Joint Co., 61 F. (2d) 751 (C. C. A. 2d 1932). If such reserves or expenses were improperly deducted, the correction must be made in the year of the deduction. See cases cited *supra*. Cf. Dallas Title & Guaranty Co., 40 B. T. A. 1021 (1939) (NA).

See Darrell, *loc. cit.* *supra* note 349, at 980-982.

³⁵¹United States v. Little War Creek Coal Co., 104 F. (2d) 483 (C. C. A. 4th 1939). Cf. United States v. Kirby Lumber Co., 284 U. S. 1, 52 Sup. Ct. 4 (1931); Helvering v. Jane Holding Corp., 109 F. (2d) 933 (C. C. A. 8th 1940), *cert. denied*, 310 U. S. 653, 60 Sup. Ct. 1102 (1940); I. T. 1547, II-1 CUM. BULL. 58 (1923). The principle has been applied to taxes properly accrued although disputed (*supra* note 332), treating the saving upon a settlement as income. Comm'r v. Central United National Bank, 99 F. (2d) 568 (C. C. A. 6th 1938). But see *supra* note 334.

The discharge of an obligation arising out of the marital relationship for less than the other party might have been entitled to does not result in income, for no taxable gain or loss may arise from that relationship. Fidelity & Columbia Trust Co. v. Lucas, 11 F. Supp. 537 (W. D. Ky. 1935), *aff'd on other grounds*, 89 F. (2d) 945 (C. C. A. 6th 1937).

³⁵²Burnet v. John F. Campbell Co., 50 F. (2d) 487, 60 App. D. C. 197 (1931); Dallas

action in which the obligation was incurred has resulted in a loss.³⁵³

When an obligation is not paid at all, the question whether the saving is taxable depends upon the same circumstances as does the taxability of savings through settlements. But, in cases where the saving *would* be taxable, a further difficulty arises from the fact that there is no agreement to fix definitely the time at which income is realized. The saving becomes taxable, if at all, when the prospect of having to pay the obligation appears so remote that it is no longer a true liability. There is no clearly defined test for determining when that occurs,³⁵⁴ and the Commissioner has a reasonable discretion

Transfer & Terminal Warehouse Co. v. Comm'r, 70 F. (2d) 95 (C. C. A. 5th 1934); Transylvania R.R. v. Comm'r, 99 F. (2d) 69 (C. C. A. 4th 1938); F. W. Sickles Co. v. United States, 31 F. Supp. 654 (Ct. Cl. 1940); Madison Railways Co., 36 B. T. A. 1106 (1937) (NA). If the insolvent debtor makes a settlement which leaves him solvent, with net assets above liabilities, he realizes income to the extent of the assets thus relieved of the claims of creditors. Lakeland Grocery Co., 36 B. T. A. 289 (1937). Cf. Walker v. Comm'r, 88 F. (2d) 170 (C. C. A. 5th 1937), *cert. denied*, 302 U. S. 692, 58 Sup. Ct. 11 (1937) (taxpayer insolvent when settlement was made but solvent when it became effective; held taxable). The Bureau does not recognize this exception.

See Darrell, *loc. cit. supra* note 349, at 988-990.

For discharges made after the enactment of the Revenue Act of 1939 (June 29, 1939), in taxable years beginning after December 31, 1938 and not later than December 31, 1942, the law provides for non-taxability of income from the discharge of indebtedness where the debtor is in "unsound financial condition", if the debt discharged is represented by any evidence of indebtedness of a corporation, which was outstanding on June 1, 1939. Revenue Act of 1939, § 215. See H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 23. Provision is made for adjusting the cost basis of the debtor's property so that ultimately he will not escape taxation upon the benefits of the settlement. See Darrell, *loc. cit. supra* note 349, at 1001-1005.

Respecting discharges under the Chandler Act, see Darrell, *loc. cit. supra* note 349, at 1005-1011. See also Regulations 103, sec. 19.22(a)-14; I. T. 1564, II-1 CUM. BULL. 59 (1923). And see the amendments to the Chandler Act by the Act of July 1, 1940 (Public. No. 699, 76th Congress); T. D. 5003, (1940) I. R. BULL. No. 35, p. 4.

³⁵³Bowers v. Kerbaugh-Empire Co., 271 U. S. 170, 46 Sup. Ct. 449 (1926) (borrowed funds had been lost in operations, so payment of less than had been received resulted in no income); Hextell v. Huston, 28 F. Supp. 521 (S. D. Iowa 1939), *appeal dismissed*, 107 F. (2d) 1016 (C. C. A. 8th 1939) (mortgage refinanced, part of debt forgiven, but land had so depreciated in value that it was worth only the amount to which debt was reduced; held, no gain realized). Cf. N. Sobel, Inc., 40 B. T. A. 1262 (1939). But cf. Comm'r v. Coastwise Transportation Corp., 71 F. (2d) 104 (C. C. A. 1st 1934), *cert. denied*, 293 U. S. 595, 55 Sup. Ct. 110 (1934); L. C. Coddon, 37 B. T. A. 393 (1938); Kalman Hirsch, 41 B. T. A. 890 (1940) (all being contrary to the *Hextell* case on similar facts).

The *Kerbaugh-Empire* case, however, has been much criticized and the view has been expressed that the exception might be abandoned in a subsequent case. MAGILL, TAXABLE INCOME (1936) 215; Rotschaefer, *The Concept of Income in Federal Taxation* (1929) 13 MINN. L. REV. 637, 660; notes (1932) 20 CALIF. L. REV. 441, and (1931) 40 YALE L. J. 960. Cf. also Burnet v. Sanford & Brooks Co., 282 U. S. 359, 51 Sup. Ct. 150 (1931), which seems inconsistent with the *Kerbaugh-Empire* case, although it attempts to draw a distinction.

See Darrell, *loc. cit. supra* note 349, at 983-988.

³⁵⁴When the taxpayer, under rules of the Interstate Commerce Commission or under his own consistent policy, credits unpaid obligations to surplus after a certain period, even short of the statute of limitations, the saving may be taxed at that time; the book entry has at least the force of an admission which the Commissioner may avail of.

in determining the time; the burden is then upon the taxpayer to show that such determination is in error.³⁵⁵ It is clear, however, that when a suit is actually pending or is threatened against the taxpayer, he may *not*, on the basis of his denial of liability, credit the contested debt to income (to offset a net loss, with the intention of adjusting it by a balancing deduction when he loses the suit and can make more advantageous use of the deduction);³⁵⁶ it is only when no claim is likely to be made, not when a claim is contested, that the possibility of payment becomes so remote as to justify a charge to income.

Chicago, R. I. & P. Ry. v. Comm'r, 47 F. (2d) 990 (C. C. A. 7th 1931), *cert. denied*, 284 U. S. 618, 52 Sup. Ct. 7 (1931) (checks not presented in two years, credited to profit and loss under I. C. C. rules); Charleston & W. C. Ry. v. Burnet, 50 F. (2d) 342, 60 App. D. C. 192 (1931) (credited unclaimed wages to profit and loss after three years, although policy was not to raise statute of limitations; held taxable); Atlantic Coast Line R.R., 23 B. T. A. 888 (1931) (same); Republic Bank & Trust Co., 36 B. T. A. 680 (1937) (collateral deposited with Comptroller of Currency to secure liability for unclaimed deposits was released after four years and credited to surplus; held taxable); Creamette Co., 37 B. T. A. 216 (1938) (obligation expired by its terms and reserve on books was eliminated). Cf. Dallas Title & Guaranty Co., 40 B. T. A. 1021 (1939) (NA). *But cf.* National Railway Time Service Co. v. Comm'r, 88 F. (2d) 904 (C. C. A. 7th 1937) (taxpayer consistently reported certain unpaid obligations as income at end of second year after they arose; when affiliation necessitated two partial returns in one year, Commissioner sought to apportion the amount so reported between the two returns; but held that it did not become income in so short a period, and under the circumstances there existing, except by the voluntary act of the taxpayer approved by the Commissioner; no income is realized, therefore, prior to that act). Income may be realized upon the dissolution and liquidation of a corporate taxpayer, freeing its assets from unpaid obligations, so far as the corporation is concerned. G. M. Standifer Construction Co., 30 B. T. A. 184 (1934), *aff'd on other grounds*, 78 F. (2d) 285 (C. C. A. 9th 1935). The passage of the statute of limitations, on the other hand, does not necessarily establish that the obligation will not be paid. North American Coal Corp. v. Comm'r, 97 F. (2d) 325 (C. C. A. 6th 1938), *aff'g* 32 B. T. A. 535 (1935) (charged back to income long after statute of limitations had expired); G. M. Standifer Construction Co., *supra* (same).

If money is received subject to an obligation to account for it, and that obligation is recognized (*i.e.*, taxpayer makes no claim of right), income may nevertheless be realized at once if the possibility of being called to account is very remote. Chicago, R. I. & P. Ry. v. Comm'r, 47 F. (2d) 990 (C. C. A. 7th 1931), *cert. denied*, 284 U. S. 618, 52 Sup. Ct. 7 (1931) (short-changing of customers); J. R. Knowland, 29 B. T. A. 618 (1933) (receipt by employer of funds in which former employees had an interest, received forty years later so unlikely that any would appear to claim it).

³⁵⁵North American Coal Corp. v. Comm'r, 97 F. (2d) 325 (C. C. A. 6th 1938), *aff'g* 32 B. T. A. 535 (1935).

³⁵⁶United States v. Little War Creek Coal Co., 104 F. (2d) 483 (C. C. A. 4th 1939), *rev'g* 25 F. Supp. 764 (S. D. W. Va. 1938). Taxpayer disputed liability upon a note (for a loan received, hence not ordinarily deductible). Pending litigation, it decided that it didn't owe the debt and reported it as income (offset by losses). It later settled and claimed deduction. District court allowed it, as converse of treatment of bad debts, permitting charge to income when taxpayer decides he will never have to pay, balancing it by a deduction when payment has to be made after all; court also drew analogy to "claim of right" rule, *supra* part 2 (a), calling it income when taxpayer claims that no liability exists. Circuit court held that there is no authority for a taxpayer to decide for himself that he does not owe a litigated claim and to charge it to income, and hence no authority for the subsequent deduction to balance improperly reported income.

g. *Summary*

Income, other than trust income, which a defendant receives under a claim of right and without restriction upon its disposition is taxable although his right to retain it is in dispute. But if it is impounded by a receiver or otherwise made unavailable to him, it has been held that its taxability is postponed until the right is determined, although the question is not free from doubt. A receiver of one's *entire* property, in any event, himself pays tax when the income is received, and no further tax is payable when the funds are released.

When a defendant loses in an action, he may deduct the judgment, in general, only if it is directly connected with business or with a transaction entered into for profit, and only if it is not in the nature of a capital expenditure. Upon grounds of public policy, criminal fines and penalties are not deductible even though connected with business. A surety, guarantor, or indorser who is compelled to pay for the principal debtor may take a bad debt deduction if the principal is insolvent, even though the obligation had no connection with business.

If a liability is deductible, no deduction may be taken, even on the accrual basis, until the liability is fixed by a settlement or by a final judgment from which no further appeals are possible, unless liability is admitted and a reasonable estimate of its amount may be made from available facts. The accrual of *tax* liabilities, however, is not postponed by the fact that the taxpayer denies liability.

When one fails to pay an obligation for which assets had been received or in respect of which expenses had been accrued, or when such an obligation is settled for less than the amount of such benefits, taxable income is realized except possibly in special circumstances in which no assets are actually made available to the taxpayer thereby.

3. *Legal Expenses*

Plaintiffs, defendants, and those who seek legal advice apart from any litigation are all interested in the question whether their legal expenses may be deducted from their taxable income. Legal expenses are never deductible unless connected with trade or business, and the mere fact that taxable income may be produced thereby does not permit a deduction if the matter does not concern one's business.³⁵⁷ The power to tax income extends to the gross

³⁵⁷*Van Wart v. Comm'r*, 295 U. S. 112, 55 Sup. Ct. 660 (1935); *Comm'r v. Field*, 42 F. (2d) 820 (C. C. A. 2d 1930); *Lansill v. Burnet*, 58 F. (2d) 512, 61 App. D. C. 107 (1932); *Monell v. Helvering*, 70 F. (2d) 631 (C. C. A. 2d 1934); *Morse v. Helvering*, 85 F. (2d) 262, 66 App. D. C. 96 (1936); *Dorr v. United States*, 18 F. Supp. 92 (D. Mass. 1937). *But cf.* A. L. Voyer, 4 B. T. A. 1192 (1926) (A), and dissent therein.

MONTGOMERY, FEDERAL INCOME TAX HANDBOOK, 1938-39, 326, attacks this rule and

income, and deductions may be taken only if they are provided for by statute.³⁵⁸ Legal expenses not connected with capital transactions are not losses,³⁵⁹ and hence the only provision for their deduction is that for the "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business."³⁶⁰

The legal expenses connected with the day-to-day operations of a business are, of course, deductible.³⁶¹ But it is not necessary that the matter be of a kind frequently arising in the taxpayer's business. Lawsuits may be rare occurrences in the life of a particular businessman, but the employment of attorneys is a common and accepted means of conducting such matters when they do occur; although perhaps unique in the life of the individual, they are not so in the life of the group.³⁶² It is sufficient if the expense proximately resulted from the conduct of the taxpayer's business³⁶³ and is not

suggests the possibility of a person subject to maximum income tax rates, retaining an attorney on a contingency basis (for a percentage of the recovery), and having to pay more than 100% tax upon the balance above attorney's fees. He suggests that such persons should assign a portion of their cause of action, a property interest, to the attorney, rather than merely agree to pay him a fee computed upon the recovery. The possibility of doing so was recognized in *Lansill v. Burnet*, *supra*, and *United States Trust Co., Exec'r*, 27 B. T. A. 1260 (1933), but in both cases no assignment was found. Cf. *Blair v. Comm'r*, 300 U. S. 5, 57 Sup. Ct. 330 (1937); *Shellabarger v. Comm'r*, 38 F. (2d) 566 (C. C. A. 7th 1930); *Brewster v. United States*, 9 F. Supp. 688, 80 Ct. Cl. 614 (1935). The cause of action which is to be partially assigned must, of course, be assignable under local law. *Quaere*, whether, since benefits are to be received in return for the assignment, taxable income might be realized upon the transfer to the extent of the excess of the value of the services over the cost basis of the cause of action, if any; taxability presumably would be postponed until the value of the services can be known at the conclusion of the action [*Burnet v. Logan*, 283 U. S. 404, 51 Sup. Ct. 550 (1931)], and the net result might be the same as if there had been no assignment. See also *Helvering v. Horst*, U. S. Sup. Ct., Nov. 25, 1940.

³⁵⁸*New Colonial Ice Co. v. Helvering*, 292 U. S. 435, 440, 54 Sup. Ct. 788 (1934); *Monell v. Helvering*, 70 F. (2d) 631 (C. C. A. 2d 1934). But see *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252, 254, 60 Sup. Ct. 209 (1939).

³⁵⁹See *Kornhauser v. United States*, 276 U. S. 145, 152, 48 Sup. Ct. 219 (1928) ("We think it is obvious that the expenditure [for attorney's fees in an accounting suit] is not a loss").

Litigation is not in itself a transaction entered into for profit, in which the legal expenses could enter into the computation of gain or loss; in theory, litigation only obtains or protects what is rightfully one's own, and no profit is involved. *Merriman v. Comm'r*, 55 F. (2d) 879 (C. C. A. 1st 1932) (the court, somewhat naively, applied that principle to a will contest); *Gertrude D. Walker*, 31 B. T. A. 1146 (1935).

If legal expenses are so connected with a capital transaction as to become a part of the cost of capital, the benefit of a deduction may, in effect, be enjoyed through a diminished gain or increased loss upon the disposition of the property, even though not connected with business. See *supra* note 223.

Legal expenses in a merger that failed were denominated a business loss in *Portland Furniture Co.*, 30 B. T. A. 878 (1934) (NA), apparently on the theory that an asset, the merger plans, became worthless; but the same kind of outlay was held a business expense in *Doernbecher Mfg. Co.*, 30 B. T. A. 973, 986 (1934) (A).

³⁶⁰Internal Revenue Code § 23 (a) (1).

³⁶¹*Ohio Sheep & Wool Growers Ass'n Co.*, 14 B. T. A. 911 (1928) (A).

³⁶²See *Welch v. Helvering*, 290 U. S. 111, 114, 54 Sup. Ct. 8 (1933); 3 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 23.38.

³⁶³*Kornhauser v. United States*, 276 U. S. 145, 153, 48 Sup. Ct. 219 (1928).

so connected with a capital transaction as to be a non-deductible capital expenditure. An officer or employee, even of a non-business enterprise, is himself engaged in business if he actively devotes time to his position,³⁶⁴ but care must be taken to distinguish the expenses arising from his employment, as such, from those incurred solely for the employer's benefit (with possible indirect benefits to the taxpayer as a stockholder).³⁶⁵

Legal expenses directly connected with capital transactions are not deductible even though incurred in trade or business, but the expenditure may usually be added to the cost basis of property for purposes of computing depreciation, depletion, or the gain or loss upon its disposition, provided the expenditure bears some reasonable relation to the asset concerned.³⁶⁶

Attorneys' fees in connection with purely personal matters, of course, are not deductible,³⁶⁷ irrespective of any possible remote or indirect connection of the matter with one's business.³⁶⁸

It is not necessary that one still be engaged in the business at the time the expense is incurred if it proximately resulted from his business. I. T. 3325, 1939-2 CUM. BULL. 151 (suit for retirement pay).

Sums paid to a third party who finances litigation for the taxpayer stand upon the same footing as attorneys' fees. *Lido Bldg. Co., Inc.*, 31 B. T. A. 461 (1934) (A). Similarly, the reimbursement of others who conduct a test case in which the taxpayer has an interest. *Findley v. United States*, 28 F. Supp. 715 (W. D. La. 1939); *Independent Brewing Co.*, 4 B. T. A. 870 (1926) (A); *George Ringler & Co.*, 10 B. T. A. 1134 (1928) (A). But one may not deduct his expenses in a lawsuit which he voluntarily entered, having no interest. *Sigmund Spitzer*, 23 B. T. A. 776 (1931).

³⁶⁴*Comm'r v. Peoples-Pittsburg Trust Co.*, 60 F. (2d) 187 (C. C. A. 3d 1932); *Foss v. Comm'r*, 75 F. (2d) 326 (C. C. A. 1st 1935) (large stockholder taking active part in management); *E. L. Potter*, 20 B. T. A. 252 (1930) (NA); *H. M. Howard*, 22 B. T. A. 375 (1931) (NA); *Isaac P. Keeler*, 23 B. T. A. 467 (1931); *Mrs. A. B. Hurt et al.*, *Exec'rs*, 30 B. T. A. 653 (1934) (A) (corporate director); *George S. Groves*, 38 B. T. A. 727 (1938) (A); I. T. 3325, 1939-2 CUM. BULL. 151 (army officer). *But cf. McGinn v. Comm'r*, 76 F. (2d) 680 (C. C. A. 9th 1935), arising under the provision for the carry-over of losses.

³⁶⁵*Deputy v. du Pont*, 60 Sup. Ct. 363 (1940). *Cf. Dalton v. Bowers*, 287 U. S. 404, 53 Sup. Ct. 205 (1932); *Malcolm G. Gibbs*, 34 B. T. A. 1028 (1936).

³⁶⁶Regulations 103, sec. 19.24-2. See *supra* note 223.

Not all capital expenditures may be added to the cost of assets, for to be so treated they must bear some reasonable relationship to the asset and must be made with respect to that property. 2 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 18.170. See *infra* notes 418, 420, 421 and 437. See also the dissent of Justice Roberts in *Deputy v. du Pont*, 308 U. S. 488, 502, 60 Sup. Ct. 363, 370 (1940), declaring that to call an expenditure a capital expenditure, under circumstances where it could not be added to the cost of an asset, was "to keep the word of promise to the ear and break it to the hope."

³⁶⁷Internal Revenue Code § 24 (a) (1).

³⁶⁸The Board and the courts have shown scant sympathy for ingenious arguments intended to assign a business purpose to personal legal expenses. See *Lloyd v. Comm'r* 55 F. (2d) 842 (C. C. A. 7th 1932) (slander respecting taxpayer's integrity, reliability, and sobriety, brought to the attention of his customers and competitors at a trade convention; sued solely to clear his business reputation; held, injury is personal and expense is not deductible); *Crocker v. Burnet*, 62 F. (2d) 991, 61 App. D. C. 342 (1933) (fight over property between taxpayer and her deceased husband's son by former marriage; although business property was concerned, controversy did not arise from business;

On the borderline between business and personal expenses are those legal expenses, other than capital expenditures, incurred by investors and trustees in the management of their properties. Until recently the rule appeared to be that an investor or trustee is engaged in business, and may deduct current expenses, if he takes an active part in the management of the business in which he invests, or if the transactions concerning his investments are substantial and frequent rather than occasional and isolated; a passive investor, trustee, or trust beneficiary is not engaged in business and his expenses are personal and non-deductible.³⁶⁹ It is a question of fact in each case, and the fact situation in each of the cited cases should be studied.³⁷⁰ However,

expenses not deductible); *Pantages Theater Co. v. Welch*, 71 F. (2d) 68 (C. C. A. 9th 1934) (successful defense of prosecution for rape; although prosecutrix was applicant for showgirl job, act charged was held to be purely personal and not connected with business); *David G. Joyce*, 3 B. T. A. 393 (1926) (defense of attack on validity of marital settlement; although taxpayer's business property would be reduced by loss of the suit, the origin of the contest is controlling); *Frank G. Robins*, 8 B. T. A. 523 (1927) (expense of settlement of separation suit claimed to be business expense because settlement was necessary to silence wife's charges of adultery, which were bad for business); *George L. [Tex] Rickard*, 12 B. T. A. 836 (1928) (successful defense of prosecution for criminal offense against patron of swimming pool managed by taxpayer; act charged held not to be an ordinary and necessary business act, immaterial that scandal cost him his position and acquittal regained it for him); *Walter S. Dickey*, 14 B. T. A. 1295, 1309 (1929), *petition for review denied*, 56 F. (2d) 917 (C. C. A. 8th 1932), *cert. denied*, 287 U. S. 606, 53 Sup. Ct. 10 (1932) (automobile stolen, alleged thief arrested but acquitted; he sued taxpayer for malicious prosecution; although automobile was used partly for business, the charge of theft, from which the suit arose, was too remote from business); *Fred S. Markham*, 39 B. T. A. 465 (1939) (expense of assisting prosecution of person who had made kidnap threats; although business property might have been reduced by payment of ransom, the expenditure nevertheless did not result from business considerations); *Kerwin H. Fulton*, 41 B. T. A. 1037 (1940) (expense of setting aside settlement of non-business action, which had been made because of threat of introduction of evidence damaging to business).

³⁶⁹Until recently, it appears to have been the Bureau's position that the ordinary and necessary expenses of obtaining income and of managing, protecting, and conserving income-producing property were business expenses. *I. T.* 2124, IV-1 CUM. BULL. 138 (1925); *I. T.* 2238, IV-2 CUM. BULL. 49 (1925); *I. T.* 2579, X-2 CUM. BULL. 129 (1931); *I. T.* 2751, XIII-1 CUM. BULL. 43 (1934). The past several years have seen a reversal of that policy. *Mim.* 4580, 1937-1 CUM. BULL. 62. The distinction made in the text is set out in *Miller v. Comm'r*, 102 F. (2d) 476 (C. C. A. 9th 1939), defining business as whatever occupies the time, attention, and labor of men for purposes of profit, but excluding the passive receipt of income and isolated transactions.

³⁷⁰An investor, trustee, or trust beneficiary was held to be engaged in business in: *Washburn v. Comm'r*, 51 F. (2d) 949 (C. C. A. 8th 1931); *Foss v. Comm'r*, 75 F. (2d) 326 (C. C. A. 1st 1935); *Kales v. Comm'r*, 101 F. (2d) 35 (C. C. A. 6th 1939); *du Pont v. Deputy*, 103 F. (2d) 257 (C. C. A. 3d 1939), *rev'd on other grounds*, 308 U. S. 488, 60 Sup. Ct. 363 (1940); *Kenan v. Bowers*, 48 F. (2d) 263, 266 (S. D. N. Y. 1930); *O'Neal v. United States*, 32 F. Supp. 799 (M. D. Ga. 1940); *Pyne v. United States*, 35 F. Supp. 81 (Ct. Cl. Oct. 7. 1940) (estate); *Grace M. Knox et al., Exec'rs*, 3 B. T. A. 143 (1925) (A) (trustee); *Henrietta Bendheim*, 8 B. T. A. 158 (1927) (trustee); *Caroline T. Kissel*, 15 B. T. A. 1270 (1929) (A); *Florence Grandin*, 16 B. T. A. 515 (1929) (NA) (trustee); *Margaret B. Sparrow et al., Trustees*, 18 B. T. A. 1 (1929) (trustee); *Chicago Title & Trust Co. et al., Trustees*, 18 B. T. A. 395 (1929) (NA) (trustee); *Alice P. Bachofen von Echt*, B. T. A. mem. (1932) (quoted in *Kales v. Comm'r*, *supra*, at 38) reconsidering and reversing 21 B. T. A. 702 (1930); *Samuel D.*

prompted by the concurring opinion of Justices Frankfurter and Reed in *Deputy v. duPont*,³⁷¹ the Second Circuit has now held that a man who merely looks after his investments, no matter how actively, and who does not hold himself out to others as engaged in the selling of goods or services, is not carrying on a business and may not deduct his investment expenses.³⁷² The Supreme Court may be expected to settle the question at the present term.

The question of the deductibility of legal expenses has arisen many times, and illustrative cases are legion.

Thus, the legal expenses involved in obtaining business income, including

Leidesdorf, 26 B. T. A. 881 (1932) (A); Grace McBride Crile, 26 B. T. A. 1020 (1932) (NA) (trust); L. T. Alverson, 35 B. T. A. 482 (1937); Austin D. Barney *et al.*, Exec'rs, 36 B. T. A. 446 (1937); Marjorie Fleming Lloyd-Smith, 40 B. T. A. 214 (1939) (trust beneficiary who took active part in management of trust); O. L. Burnett, 40 B. T. A. 604 (1939) (NA) (same); Alice duPont Ortiz, 42 B. T. A. 173 (1940) (NA). Cf. Augusta Bliss Reese, 29 B. T. A. 565 (1933) (A) (trust); Bessie B. Hopkinson, 42 B. T. A. 580 (1940). Respecting speculators, see Ignaz Schwinn, 9 B. T. A. 1304 (1928) (A); Sam J. Reckford, 40 B. T. A. 899 (1939); I. T. 1818, II-2 CUM. BULL. 39 (1923); G. C. M. 9958, X-2 CUM. BULL. 158 (1931); Mim. 3883, X-2 CUM. BULL. 180 (1931). Early cases in the Board, especially those involving trusts, should be used with caution, even though acquiesced in, in view of recent developments; little question was raised in those cases respecting the nature of the activities, and it seems to have been assumed that since a trustee did not act for himself, his expenses were not personal and therefore must be business expenses. Cf. *Comm'r v. Wurts-Dundas*, 54 F. (2d) 515 (C. C. A. 2d 1931), disapproved in *Van Wart v. Comm'r*, 295 U. S. 112, 55 Sup. Ct. 660 (1935). See *City Bank Farmers Trust Co. v. Comm'r*, 112 F. (2d) 457, 459 (C. C. A. 2d 1940).

An investor, trustee, or trust beneficiary was held *not engaged in business* in: *Moynier v. Welch*, 97 F. (2d) 471 (C. C. A. 9th 1938); *Kane v. Comm'r*, 100 F. (2d) 382 (C. C. A. 2d 1938), *aff'g* Helen W. Heilbroner, 34 B. T. A. 1200 (1936); *Miller v. Comm'r*, 102 F. (2d) 476 (C. C. A. 9th 1939); *Higgins v. Comm'r*, 111 F. (2d) 795 (C. C. A. 2d 1940), *cert. granted*, 61 Sup. Ct. 34 (Oct. 14, 1940); *City Bank Farmers Trust Co. v. Comm'r*, *supra*, *aff'g* 39 B. T. A. 29 (1939) (trust); *Kenan v. Bowers*, 48 F. (2d) 263 (S. D. N. Y. 1930) (trust beneficiary); *Dorr v. United States*, 18 F. Supp. 92 (D. Mass. 1937) (trust); *Squier v. United States*, 20 F. Supp. 917 (D. N. J. 1937) (former trustee); *Leo P. Bergin*, 20 B. T. A. 1002 (1930) (trust beneficiary); *Grace McBride Crile*, 26 B. T. A. 1020 (1932) (trust beneficiary); *Augusta Bliss Reese*, 29 B. T. A. 565 (1933) (A) (trust beneficiary); *Malcolm G. Gibbs*, 34 B. T. A. 1028 (1936); *Estate of Henry N. Brawner*, 36 B. T. A. 884 (1937); *George Vanderbilt Trust*, 36 B. T. A. 967 (1937) (trust); *Lewis Spencer Morris*, Trustee, 40 B. T. A. 987 (1939) (trust); *Estate of C. R. Hubbard*, 41 B. T. A. 628 (1940) (estate); *Lillie S. Wedgeforth*, 42 B. T. A. 633 (1940) (trust beneficiary with reserved right to advise on investments).

Whether a trust may deduct expenses depends not upon whether the trustee is in the business of managing trusts but whether the management of the particular trust is sufficiently active to constitute a business. *City Bank Farmers Trust Co. v. Comm'r*, *supra*. And the test is not what the trustee has power to do under the trust instrument but what he actually does. *George Vanderbilt Trust*, *supra*; *Lewis Spencer Morris*, *supra*.

³⁷¹308 U. S. 488, 499, 60 Sup. Ct. 363, 369 (1940). Justices Frankfurter and Reed limited the term "business" to "holding one's self out to others as engaged in the selling of goods and services." The majority, resting the case on other grounds, assumed *arguendo* that the taxpayer was engaged in business in "conserving and enhancing his estate."

³⁷²*Higgins v. Comm'r*, 111 F. (2d) 795 (C. C. A. 2d 1940), *cert. granted*, 61 Sup. Ct. 34 (Oct. 14, 1940).

the collection of business debts and compensation and the prosecution of accounting suits against business agents, are deductible.³⁷³ Likewise the defense of an action for a business debt, the defense of one's right to business income, and an agent's defense of an accounting suit give rise to deductible expenses.³⁷⁴ The expenses of patent litigation, other than an interference proceeding, may be deducted if it is connected with the taxpayer's business and if it does not result in perfecting the title or prolonging the life of the patent.³⁷⁵ The expenses of a court test of the constitutionality of legislation

³⁷³E. C. Miner Lithographing Co., 1 B. T. A. 588 (1925) (A) (cost of getting judgment for business debt); Charles Henry Matlage, 3 B. T. A. 242 (1925) (A) (cost of unsuccessful attempt to recover misappropriated funds from bookkeeper); E. S. Briant, Adm'r, 6 B. T. A. 651 (1927) (NA) (collection of business debt); Richard Croker, Jr., 12 B. T. A. 408 (1928) (A) (agent's suit against principal for advances); Bula E. Croker, 27 B. T. A. 588 (1933) (A) (accounting suit against business agent); Ulster & Delaware R. R., 25 B. T. A. 109 (1932) (A) (expense of negotiating settlement with Director General of Railroads); I. T. 3325, 1939-2 CUM. BULL. 151 (retired army officer's suit for increased retirement pay). See *Umsted v. Comm'r*, 72 F. (2d) 328 (C. C. A. 8th 1934) and *Swastika Oil & Gas Co.*, 40 B. T. A. 797 (1939) (A), in which the Commissioner sought to tax only the net recovery after legal expenses, presumably because business matters were involved.

Expenses of special proceedings for the discovery of a business debtor's property, or to set aside a fraudulent conveyance by him, are deductible. *H. R. MacMillan*, 14 B. T. A. 1367 (1929), *appeal dismissed*, 67 F. (2d) 1003 (C. C. A. 9th 1934); *Swastika Oil & Gas Corp.*, *supra*.

The expense of collecting a business debt as assignee is held to be a business expense rather than a capital expenditure. *Alexander Sprunt & Son, Inc.*, 64 F. (2d) 424 (C. C. A. 4th 1933); *H. R. MacMillan*, *supra*.

³⁷⁴*Kornhauser v. United States*, 276 U. S. 145, 48 Sup. Ct. 219 (1928) (defense of accounting suit by partner, for prior earnings); *Lena G. Hill*, 8 B. T. A. 1159 (1927) (A) (defense against claims of materialmen, in business); *Richard Croker, Jr.*, 12 B. T. A. 408 (1928) (A) (agent's defense of accounting suit); *O'Day Investment Co.*, 13 B. T. A. 1230 (1928) (A) (former minority stockholder of closed corporation sued for accounting; corporation may deduct expenses of defense); I. T. 3412, (Sept. 23, 1940) I. R. BULL. No. 39, p. 5 (defense of N.L.R.B. proceeding).

It has been suggested that such expenses should not be held deductible unless the defense is made in good faith, since the unjustifiable resistance of a claim is not "ordinary and necessary" business conduct. 3 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 23.55. *But cf.* *Foss v. Comm'r*, 75 F. (2d) 326 (C. C. A. 1st 1935) (expense of unsuccessful defense of action for milking corporation, allowed).

Respecting the expense of defending against liabilities of another which have been assumed, *cf. infra* note 394.

³⁷⁵*F. Meyer & Bro. Co.*, 4 B. T. A. 481 (1926) (A) (defense); *A. R. R.* 98, 2 CUM. BULL. 105 (1920) (prosecution). *Cf.* *Ward v. United States*, 32 F. Supp. 743 (D. Mass. 1940) (denying right to spread expense over life of patent, on ground it was current business expense). Although in effect incurred in defense of title to the patent, such expenses are not held to be capital expenditures. In a later Bureau ruling, the former ruling, *supra*, was distinguished and apparently left in full force; it was declared that the elements which enter into the cost basis of a patent, to be amortized over its life, are expressly enumerated in the regulations (now Regulations 103, sec. 19.23 (e)-7), and attorneys' fees subsequent to the granting of the patent were said not to be included and, therefore, were currently deductible if connected with business. *S. M.* 2423, III-2 CUM. BULL. 157 (1924). On the other hand, legal expenses in obtaining the patent and in interferences are capital expenditures. *Hazeltine Corp. v. Comm'r*, 89 F. (2d) 513, 522 (C. C. A. 3d 1937).

affecting one's business are deductible,³⁷⁶ but the legal and other expenses of promoting or defeating legislation are usually denied deduction.³⁷⁷

The expenses of prosecuting and defending tort actions arising out of one's business are deductible.³⁷⁸ The right to deduct is not affected by the fact that the acts were done on behalf of one's employer, or in connection with such employment, since the officer or employee is himself engaged in the business of serving the employer and the liability arose from that business.³⁷⁹

³⁷⁶Independent Brewing Co., 4 B. T. A. 870 (1926) (A); George Ringler & Co., 10 B. T. A. 1134 (1928) (A).

³⁷⁷Regulations 103, secs. 19.23(o)-1 and 19.23(q)-1; Old Mission Portland Cement Co. v. Comm'r, 69 F. (2d) 676 (C. C. A. 9th 1934), *aff'd on other grounds*, 293 U. S. 289, 55 Sup. Ct. 158 (1934); Sunset Scavenger Co. v. Comm'r, 84 F. (2d) 453 (C. C. A. 9th 1936); Adler Co., 10 B. T. A. 849 (1928); Mrs. William P. Kyne, 35 B. T. A. 202 (1936); Lelia S. Kirby, 35 B. T. A. 578 (1937), *mod. on other grounds*, 102 F. (2d) 115 (C. C. A. 5th 1939).

Cf. contra: Lucas v. Wofford, 49 F. (2d) 1027 (C. C. A. 5th 1931) (permitting deduction of fee of attorney to prepare a bill and present it to Governor and legislative committees); Los Angeles & Salt Lake R. R., 18 B. T. A. 168 (1929) (NA); Textile Mills Securities Corp., 38 B. T. A. 623 (1938) (NA).

³⁷⁸Bliss v. Comm'r, 57 F. (2d) 984 (C. C. A. 5th 1932) (evicting trespassers from oil lands); Foss v. Comm'r, 75 F. (2d) 326 (C. C. A. 1st 1935) (defending suit for milking corporation managed by taxpayer); Anderson v. Comm'r, 81 F. (2d) 457, 104 A. L. R. 676 (C. C. A. 10th 1936) (damage suit arising from driving automobile on business); E. S. Briant, Adm'r, 6 B. T. A. 651 (1927) (NA) (defense of suit to cancel business debt for usury); Peter Frees, Jr., 12 B. T. A. 737 (1928) (A) (defense against liability for funds embezzled by clerk); H. M. Howard, 22 B. T. A. 375 (1931) (NA) (mismanagement of corporation); Isaac P. Keeler, 23 B. T. A. 467 (1931) (same); Matson Navigation Co., 24 B. T. A. 14 (1931) (defense of suit for conspiracy to obtain business property from Alien Property Custodian at inadequate price); Mrs. A. B. Hurt *et al.*, Exec'rs, 30 B. T. A. 653 (1934) (A), *appeal dismissed*, 90 F. (2d) 1010 (C. C. A. 5th 1937) (alleged misappropriation of corporate funds by director); International Shoe Co., 38 B. T. A. 81 (1938) (A) (defense of suit for unfair competition); O. D. 1117, 5 CUM. BULL. 121 (1921) (defense of personal injury suit connected with business); S. M. 4078, V-1 CUM. BULL. 226 (1926) (malpractice, *etc.*).

Cf. Murphy Oil Co. v. Burnet, 55 F. (2d) 17, 26 (C. C. A. 9th 1932), *aff'd on other grounds*, 287 U. S. 299, 53 Sup. Ct. 161 (1932) (expense of defense of fraud action held to be a capital expenditure when property obtained by alleged fraud is retained in settlement); Crowley v. Comm'r, 89 F. (2d) 715 (C. C. A. 6th 1937) (taxpayer was sued for mismanagement of corporation; settled by buying plaintiff's stock; defense expenses held to be a capital expenditure); Clark Thread Co., 28 B. T. A. 1128 (1933), *aff'd*, 100 F. (2d) 257 (C. C. A. 3d 1938) (expense of prosecuting suit for trade name infringement held to be a capital expenditure when settlement resulted in elimination of such competition, producing intangible benefits of indefinite duration); J. I. Case Co. v. United States, 32 F. Supp. 754 (Ct. Cl. 1940) (similar).

It appears that the public policy which forbids the deduction of the expenses of an unsuccessful criminal defense, *infra* note 397, does not apply to private wrongs, and tort defense expenses are deductible no matter what the result of the suit. *Foss v. Comm'r*, *supra*. *Cf. Helvering v. Hampton*, *supra* note 269 (involving deduction of fraud liability, legal expense question not having been properly raised). The *Foss* case, however, was expressly disapproved on this point, by dictum, in *National Outdoor Adv. Bureau v. Helvering*, 89 F. (2d) 878, 881 (C. C. A. 2d 1937). Respecting civil liabilities to the Government, see *infra* notes 399 and 400.

In general, see note (1936) 104 A. L. R. 680, 689.

³⁷⁹*Foss v. Comm'r*, H. M. Howard, Isaac P. Keeler, Mrs. A. B. Hurt, *supra* note 378. *Cf. George S. Groves*, 38 B. T. A. 727 (1938) (A). See *supra* note 364.

The expenses of defending disbarment proceedings against an attorney³⁸⁰ and *quo warranto* proceedings against a corporation³⁸¹ are deductible business expenses, at least if no criminal acts are established. On the other hand, the expenses of suits for torts not connected with one's business may not be deducted, even from the income produced by the suit.³⁸²

The expenses of marital actions and similar matters are, of course, personal and non-deductible.³⁸³

As has already been suggested, the expenses of suits to secure non-business income are not deductible. In this category fall suits to obtain or accelerate income from trusts and legacies.³⁸⁴ Likewise the legal expenses connected with the management of one's income or estate, at least by one not sufficiently active in that respect to be considered engaged in business, are not deductible.³⁸⁵ When a trustee is surcharged for improper investments, he

³⁸⁰I. T. 2252, V-1 CUM. BULL. 227 (1926), overruling I. T. 2168, IV-1 CUM. BULL. 140 (1925). *But cf.* Payson Tinkoff, B. T. A. Mem. Docket No. 80156, Aug. 2, 1938, 1938-4 C. C. H. ¶ 7620-G (disbarment for crime; expense not deductible).

³⁸¹G. C. M. 19976, 1938-1 CUM. BULL. 120 (successful defense of proceeding by State to revoke right to do business in state, for alleged violation of law). The ruling implies that the expenses would be non-deductible if violations of law were established.

³⁸²Lloyd v. Comm'r, 55 F. (2d) 842 (prosecution of slander suit, not deductible although business reputation was affected); Sanderson v. Burnet, 63 F. (2d) 268, 61 App. D. C. 377 (1933) (divorced wife sued husband for accounting for his handling of her finances during marriage; defense expenses not deductible); L. Oransky, 1 B. T. A. 1239 (1925) (defense of action for injuries in automobile accident; expense held not to be a loss of property from casualty); Walter S. Dickey, 14 B. T. A. 1295, 1309 (1929), *petition for review denied*, 56 F. (2d) 917 (C. C. A. 8th 1932), *cert. denied*, 287 U. S. 606, 53 Sup. Ct. 10 (1932) (defense of malicious prosecution suit brought by accused thief; held, not a loss from theft); Samuel E. Mulholland, 16 B. T. A. 1331 (1929) (like *Oransky* case).

³⁸³Regulations 103, sec. 19.24-1; Sanderson v. Burnet, *supra* note 382; David G. Joyce, 3 B. T. A. 393 (1926) (defense against wife's attack upon validity of property settlement); Frank G. Robins, 8 B. T. A. 523 (1927) (separation suit); I. T. 1804, II-2 CUM. BULL. 61 (1923) (breach of promise to marry). *Cf.* George D. Mann, 33 B. T. A. 281 (1935) (divorce; corporation paid expenses).

³⁸⁴*Van Wart v. Comm'r*, 295 U. S. 112, 55 Sup. Ct. 660 (1935); *Comm'r v. Field*, 42 F. (2d) 820 (C. C. A. 2d 1930); *Walker v. Comm'r*, 63 F. (2d) 351 (C. C. A. 3d 1933), *cert. denied*, 289 U. S. 746, 53 Sup. Ct. 690 (1933); *Morse v. Helvering*, 85 F. (2d) 262, 66 App. D. C. 96 (1936); *Gertrude D. Walker*, 31 B. T. A. 1146 (1935); *Charles S. Davis, Trustee*, 35 B. T. A. 1001 (1937) (beneficiary's expenses in suit for breach of trust); *Adolph Bernard Spreckels*, 37 B. T. A. 709 (1938), *rev'd on other grounds*, 101 F. (2d) 721 (C. C. A. 9th 1939) (legal expenses in contesting executor's accounting, seeking to reduce his fees and those of his attorney); *Gloria Laura Morgan Vanderbilt*, 39 B. T. A. 43 (1939), *aff'd w.o. op.*, 107 F. (2d) 1023 (C. C. A. 2d 1939), *cert. denied*, 309 U. S. 683, 60 Sup. Ct. 723 (1940).

It was formerly held that when a trustee or guardian thus sought income, having no personal interest in the matter, it was a business expense. *Comm'r v. Wurts-Dundas*, 54 F. (2d) 515 (C. C. A. 2d 1931), overruled by the *Van Wart* case, *supra*.

Respecting will contests, see *infra* note 424.

³⁸⁵*Dorr v. United States*, 18 F. Supp. 92 (D. Mass. 1937) (drafting trust instrument; investment advice); *Helen S. Pennell*, 4 B. T. A. 1039 (1926) (preparation of will; investment advice); *Esther Rentie*, 21 B. T. A. 1230 (1931) (defense of incompetency proceedings); *Robert Lyons Hague*, 24 B. T. A. 288 (1931) (investigation of proposed investment; not a loss in transaction entered into for profit, for transaction not entered);

may deduct the expense of his defense only if he is deemed actively engaged in the business of managing the trust or trusts.³⁸⁶ The legal and other expenses of managing a decedent's estate, even though its activities are sufficient to constitute a business, are not deductible business expenses³⁸⁷ but are administrative expenses, to be deducted from corpus for *estate* tax purposes,³⁸⁸ so long as they are a part of the normal and usual processes of administration and of preparing the estate for distribution; however, if the estate is required to be kept intact beyond the usual period of administration, the expenses connected with the current business of the estate may be deducted for income tax purposes.³⁸⁹

When a taxpayer employs an attorney or other expert to aid in the preparation of a tax return, the expense is not deductible unless the tax is connected with the taxpayer's trade or business.³⁹⁰ Similarly, the deductibility

Bula E. Croker, 27 B. T. A. 588, 591 (1933) (settlement of estate, etc.); Estate of Henry N. Brawner, 36 B. T. A. 884 (1937) (investigation of prospective investment); Fred S. Markham, 39 B. T. A. 465 (1939) (investigation of threat to kidnap taxpayer's child, and assistance in prosecution and conviction; not deductible although ransom would have depleted income-producing property); Mim. 4580, 1937-1 CUM. BULL. 62, revoking I. T. 2124, IV-1 CUM. BULL. 138 (1925), as of Jan. 1, 1937 (securing appointment of guardian to receive minor's share of estate). *Contra* (under former broad interpretation of "business"): I. T. 2238, IV-2 CUM. BULL. 49 (1925) (expenses of committee for incompetent, in managing and preserving income-producing property, allowed).

³⁸⁶Stuart v. Comm'r, 84 F. (2d) 368 (C. C. A. 1st 1936), *aff'd* 32 B. T. A. 574 (1935), *cert. denied*, 299 U. S. 575, 57 Sup. Ct. 38 (1936) (denying deduction); John Abbott, 38 B. T. A. 1290 (1938) (A) (granting deduction to one actively engaged in trusteeships); Kerwin H. Fulton, 41 B. T. A. 1037 (1940) (denying deduction). *Cf.* Margaret B. Sparrow *et al.*, Trustees, 18 B. T. A. 1 (1929) (*trust* deducted expenses of defense of suit for accounting and to upset accumulation provisions); Squier v. United States, 20 F. Supp. 917 (D. N. J. 1937).

³⁸⁷Hartley v. Comm'r, 72 F. (2d) 352, 356 (C. C. A. 8th 1934), *aff'd on other grounds*, 295 U. S. 216, 55 Sup. Ct. 756 (1935); B. Mahler, 32 B. T. A. 644 (1935); George W. Oldham *et al.*, Exec'rs, 36 B. T. A. 523 (1937) (full discussion); Estate of C. R. Hubbard, 41 B. T. A. 628 (1940); A. R. R. 284, 3 CUM. BULL. 208 (1925); I. T. 2238, IV-2 CUM. BULL. 49 (1925).

³⁸⁸Internal Revenue Code § 812 (b).

It has been held that there is no necessary inconsistency in allowing such expenses as deductions both to the executor as a business expense for income tax purposes, if his activities on behalf of the estate constitute a business, and to the estate as administrative expenses, for estate tax purposes. *Adams v. Comm'r*, 110 F. (2d) 578, 583 (C. C. A. 8th 1940). But see Regulations 103, sec. 19.24-2.

³⁸⁹William W. Mead *et al.*, Exec'rs, 6 B. T. A. 752 (1927) (A); George W. Seligman, Exec'r, 10 B. T. A. 840 (1928) (A); Thomas H. Franklin *et al.*, Exec'rs, 11 B. T. A. 148 (NA). See George W. Oldham, Exec'r, *supra* note 387. *Cf.* *Adams v. Comm'r*, 110 F. (2d) 578 (C. C. A. 8th 1940) (estate tax case; abnormal period of administration, *per se*, does not require disallowance of expenses if actually engaged in settling up estate and if expenses are necessary and reasonable); Estate of William G. Peckham, 19 B. T. A. 1020 (1930) (estate tax case, disallowing administrative expenses after first three years).

³⁹⁰*Not deductible*: *Hutchings v. Burnet*, 58 F. (2d) 514, 61 App. D. C. 109 (1932) (income tax return concerning royalties of passive investor); *Dorr v. United States*, 18 F. Supp. 92 (D. Mass. 1937); Charles Henry Mattlage, 3 B. T. A. 242 (1925); Isaac P. Keeler, 23 B. T. A. 467 (1931) (denied even though taxpayer's income was derived from a partnership business); Cornelia W. Roebing, 37 B. T. A. 82, 86 (1938);

of the expenses of contesting tax liability or suing for a refund depends upon whether the tax was incurred in trade or business;³⁹¹ the test is not whether the taxpayer is *engaged* in trade or business but whether the particular matter with respect to which the additional assessment or the claim for refund

I. T. 2819, XIII-2 CUM. BULL. 129 (1934) (passive investor).

Deductible: J. W. Forgeus, 6 B. T. A. 291 (1927) (A) (engaged in business); O'Neal v. United States, 32 F. Supp. 799 (M. D. Ga. 1940) (active investor).

³⁹¹Expenses of estate and inheritance tax contests are not deductible even though the property involved is business property, since the tax does not result from any business transaction. Leach v. Comm'r, 50 F. (2d) 371 (C. C. A. 1st 1931); Lindley v. Comm'r, 63 F. (2d) 807 (C. C. A. 2d 1933); Hall v. Helvering, 70 F. (2d) 284, 63 App. D. C. 118 (1934); Monell v. Helvering, 70 F. (2d) 631 (C. C. A. 2d 1934); James C. Ayer *et al.*, Trustees, 26 B. T. A. 9 (1932), *appeal dismissed*, 63 F. (2d) 231 (C. C. A. 2d 1933), *cert. denied*, 289 U. S. 752, 53 Sup. Ct. 696 (1933); Elmon C. Gillette, 29 B. T. A. 561 (1933), *aff'd on other grounds*, 76 F. (2d) 6 (C. C. A. 2d 1935); B. Mahler, 32 B. T. A. 644 (1935); Estate of Ida B. Stone, 40 B. T. A. 814 (1939). *Contra*: Florence Grandin, 16 B. T. A. 515 (1929) (NA) (holding duty of trustee to preserve and protect trust property makes it part of his business to recover excessive estate taxes); Chicago Title & Trust Co. *et al.*, Trustees, 18 B. T. A. 395 (1929) (NA) (same). Cf. John A. Loetscher *et al.*, Exec'rs, 14 B. T. A. 228, 233 (1928), *rev'd on other grounds*, 46 F. (2d) 835, 60 App. D. C. 38 (1931) (cost of estate tax contest deductible from estate as administrative expense, for estate tax purposes).

Expenses of income tax contests are deductible only if the item in suit is connected with one's business. Held *deductible* in: Kales v. Comm'r, 101 F. (2d) 35, 122 A. L. R. 211 (C. C. A. 6th 1939) (active investor; contest concerned dividends); Caroline T. Kissell, 15 B. T. A. 1270 (1929) (A) (active investor; contest concerned loss on bonds and other items connected with investments); Flemmon E. Gloyd, 19 B. T. A. 966 (1930) (A), *aff'd on other grounds*, 63 F. (2d) 649 (C. C. A. 8th 1933), *cert. denied*, 290 U. S. 633, 54 Sup. Ct. 52 (1933) (corporate income tax); Louise C. Slack *et al.*, Exec'rs, 35 B. T. A. 271 (1937), *appeal dismissed*, 91 F. (2d) 1011 (C. C. A. 9th 1937) (business of renting real estate; contest concerned business income, including gains on sales, and whether it should be taxed to taxpayer alone or to marital community); Estate of Henry N. Brawner, 36 B. T. A. 884 (1937) (A) (business income); O. L. Burnett, 40 B. T. A. 604 (1939) (NA) (beneficiary of trust took active part in its management, so trust income held business income, and deducted expense of contest over tax upon such income); O. D. 849, 4 CUM. BULL. 123 (1921). Cf. Estate of Henry E. Huntington, 36 B. T. A. 698, 728 (1937) (expense of estate's contest of decedent's income tax held deductible from *corpus* as administrative expense, for estate tax purposes); Ruby W. C. Jones, Exec'x, 32 B. T. A. 728 (1935) (estate's contest of decedent's income tax held to be related to *corpus* and not deductible from current income). Held *not deductible* in: Frank C. Hermann, 20 B. T. A. 899 (1930) (no proof of connection with business); A. C. Barnes, 21 B. T. A. 690 (1930) (even though income came from salaries, etc., from active management of corporation; contested item not stated); Louis Knhn, 22 B. T. A. 975 (1931) (capital gain contest; sale of stock not incident to business of *managing* corporation; not an *active investor*); B. Mahler, 32 B. T. A. 644 (1935); Malcolm G. Gibbs, 34 B. T. A. 1028 (1936) (same as *Knhn* case); G. C. M. 263, V-2 CUM. BULL. 162 (1926) (contest concerned charitable contribution).

Expenses of contesting other business taxes have been held deductible in Comm'r v. Chicago Dock & Canal Co., 84 F. (2d) 288 (C. C. A. 7th 1936) (special assessment upon business property); B. E. Levinstein, 19 B. T. A. 99 (1930) (liquor tax); E. L. Bruce Co., 19 B. T. A. 777 (1930) (A) (intangible tax on corporation); Mm. 3958, XI-2 CUM. BULL. 33, 35 (1932) (customs duties).

See note (1939) 122 A. L. R. 218.

It should be noted that *taxes*, with specified exceptions, are deductible whether or not connected with business [Internal Revenue Code § 23 (c)], but the cost of a contest must be deducted, if at all, as a business expense.

is made arose out of the taxpayer's trade or business.³⁹² Although taxes paid for a predecessor enterprise as a result of transferee liability or assumption of liability are non-deductible capital expenditures,³⁹³ the expense of defending against such liability is held to be currently deductible, if incurred in trade or business.³⁹⁴

The deductibility of the expenses of defending a criminal prosecution involves an additional consideration, the public policy against the deduction of the expenses of crime. Therefore, in order to deduct such expenses, the taxpayer must establish both that the acts done or alleged to have been done, which gave rise to the prosecution, were proximately connected with his business, and that he was not convicted.³⁹⁵ If the acts charged were not thus connected with his business, the expenses are, of course, personal and non-deductible;³⁹⁶ and if the taxpayer was convicted and it is thus established that his acts were criminal, the acts cannot be regarded as arising from the ordinary and proper conduct of his business.³⁹⁷ If, on the other

³⁹²G. C. M. 263, V-2 CUM. BULL. 162 (1926).

³⁹³See *supra* note 263.

³⁹⁴H. E. Bullock, 16 B. T. A. 451 (1929) (NA) (partnership succeeded corporation, defended tax penalty suit against corporation); Benjamin Paschal O'Neal, 18 B. T. A. 1036 (1930) (A) (stockholder defended against corporate tax after liquidation; question whether *he* was engaged in business not discussed); Flemmon E. Gloyd, 19 B. T. A. 966 (1930) (A), *aff'd on other grounds*, 63 F. (2d) 649 (C. C. A. 8th 1933) (same); Isabel G. Sproehnie, Exec'x, 20 B. T. A. 417 (1930) (NA) (like *Bullock* case); Fred T. Ley, 21 B. T. A. 216 (1930) (NA) (shareholder defended against tax on business trust after liquidation); Joshua C. Kelley, 38 B. T. A. 1292 (1938) (A) (partnership succeeded business trust and assumed liabilities). *Cf. contra*: Baxter D. Whitney & Son, Inc., 20 B. T. A. 380 (1930) (corporation took over assets of another, assuming all taxes arising out of transaction; expense of contest of those taxes not deductible); Caldwell & Co., 26 B. T. A. 790 (1932), *aff'd w.o. op.*, 65 F. (2d) 1012 (C. C. A. 2d 1933) (similar); Ida B. Stone, 40 B. T. A. 814 (1939) (legatee was sued for estate tax deficiency, as transferee; Board rests largely upon personal expense ground, but also calls it capital expenditure). *Cf. also* Sigmund Spitzer, 23 B. T. A. 776 (1931) (nothing in record to show how taxpayer would have been liable for tax upon dissolved corporation, which he defended; hence, held to be a voluntary expenditure).

See note (1939) 122 A. L. R. 218, 221.

³⁹⁵See note (1936) 104 A. L. R. 680, 683.

³⁹⁶*Pantages Theater Co. v. Welch*, 71 F. (2d) 68 (C. C. A. 9th 1934) (applicant for position as showgirl charged rape; acquitted, but act charged was not a business act); John Stephens, 2 B. T. A. 724 (1925) (acquitted of fraud; failed to establish connection with business); George L. [Tex] Rickard, 12 B. T. A. 836 (1928) (acquitted of criminal offense against patron of swimming pool under his management; held, not a business act, and immaterial that the scandal cost him his job).

³⁹⁷*Burroughs Bldg. Material Co. v. Comm'r*, 47 F. (2d) 178 (C. C. A. 2d 1931) (pleaded guilty under state price-fixing law); *Gould Paper Co. v. Comm'r*, 72 F. (2d) 698 (C. C. A. 2d 1934) (pleaded *nolo contendere* in anti-trust prosecution); *Norvin R. Lindheim*, 2 B. T. A. 229 (1925) (convicted under Trading with the Enemy Act); *Columbus Bread Co.*, 4 B. T. A. 1126 (1926) (pleaded guilty under state anti-trust law); *Wolf Mfg. Co.*, 10 B. T. A. 1161 (1928) (convicted of conspiracy to defraud Government); *B. E. Levinstein*, 19 B. T. A. 99 (1930) (pleaded guilty to liquor violation); *Sanitary Earthenware Specialty Co.*, 19 B. T. A. 641 (1930) (convicted under Sherman Act); *John W. Thompson Estate*, 21 B. T. A. 568 (1930), *appeal dismissed*, 62 F. (2d) 1082 (C. C. A. 8th 1932) (convicted of conspiracy to defraud Government); *O. D. 952*,

hand, the acts charged are proximately connected with his business, and he was not found guilty of any criminal acts, the courts have held, after early wavering, that the expenses of a criminal defense are deductible as ordinary and necessary business expenses.³⁹⁸ A civil suit by the Government for the purpose of enjoining or penalizing a violation of law is treated in the same manner as a criminal prosecution, and the expenses of defense are not deductible unless the suit proved unjustified.³⁹⁹ It also appears that a civil action by the Government for fraud is so treated⁴⁰⁰ and is not assimilated to the rule respecting actions for private torts, in which public policy is not involved.⁴⁰¹

The question of the deductibility of legal expenses incurred in corporate matters by the corporation and its officers and stockholders requires con-

4 CUM. BULL. 209 (1921) (druggist convicted of narcotic violation).

Although an attorney's expenses in resisting disbarment are ordinarily deductible [I. T. 2252, V-1 CUM. BULL. 227 (1926)], they are not so deductible when the disbarment results from a criminal conviction. Payson Tinkoff, B. T. A. Mem. Docket No. 80156, Aug. 2, 1938, 1938-4 C. C. H. ¶ 7620-G.

³⁹⁸Comm'r v. Continental Screen Co., 58 F. (2d) 625 (C. C. A. 6th 1932) (Federal Trade Commission investigation of alleged violation of Sherman Act; dismissed for lack of proof); Comm'r v. Peoples-Pittsburgh Trust Co., 60 F. (2d) 187 (C. C. A. 3d 1932) (corporate officer indicted for fraudulently preparing corporation's income tax returns; acquitted; prosecution resulted from acts in course of his business of serving as an officer, so deductible); Citron-Byer Co., 21 B. T. A. 308 (1930) (NA) (indictments for conspiracy to defraud Government, one dismissed for want of prosecution, the other for failure of proof); William C. Kottemann, B. T. A. Mem. (1934) (quoted in Kottemann v. Comm'r, 81 F. (2d) 621, 622 (C. C. A. 9th 1936), which affirmed on other grounds); Hal Price Headley, 37 B. T. A. 738 (1938) (A) (indictment for "doping" race horses, dismissed after suppression of evidence; taxpayer's business was breeding and racing horses, so deductible).

Early cases and rulings had held that expenses of a criminal defense were always personal, irrespective of result. Sarah Backer, 1 B. T. A. 214 (1924) (acquitted of perjury in connection with business investigation; not deductible); Atlantic Terra Cotta Co., 13 B. T. A. 1289 (1928) (Sherman Act prosecution; Board does not state result of prosecution, denying deduction in any event); S. R. 3137, IV-1 CUM. BULL. 170 (1925) (holding expenses of criminal defense "under no circumstances" deductible). Acquiescence in the *Headley* case indicates that the rule stated in the text is now accepted.

³⁹⁹Gould Paper Co. v. Comm'r, 72 F. (2d) 698 (C. C. A. 2d 1934); National Outdoor Advertising Bureau v. Helvering, 89 F. (2d) 878 (C. C. A. 2d 1937), *rev'g* 32 B. T. A. 1025 (1935); General Outdoor Advertising Co. v. Helvering, 89 F. (2d) 882 (C. C. A. 2d 1937), *rev'g* 32 B. T. A. 1011 (1925). A consent decree establishes the justification for the suit, even though (as in the two last named cases) it contains no finding that wrongful acts had been done, for it shows that resistance to the decree forbidding threatened violations was unjustified.

Respecting actions for penalties, compare the cases cited *supra* notes 237 and 238, concerning non-deductibility of the penalties themselves.

⁴⁰⁰McDuffie v. United States, 19 F. Supp. 239, 85 Ct. Cl. 212 (1937) (no discussion, but citation of *Gould Paper* case, *supra* note 399, suggests that this is the basis for denying deduction). In *Mrs. A. B. Hurt et al., Exec'rs*, 30 B. T. A. 653 (1934) (A), *appeal dismissed*, 90 F. (2d) 1010 (C. C. A. 5th 1937), expenses of defending an action by the United States Government against a director for misappropriating funds which it had paid to his corporation to finance a construction contract were allowed, the suit having been discontinued without prejudice.

⁴⁰¹*Supra* note 378.

sideration of the capital expenditure question, as well as of the separate entities of the corporation and its stockholders and managers.⁴⁰²

Thus, legal expenses incurred in an effort to get control of a business are non-deductible capital expenditures if they result in the acquisition of an increased interest in the enterprise,⁴⁰³ but there is authority to the effect that such expenses are currently deductible if they merely maintain the *status quo* or if the effort to increase one's interest is unsuccessful, provided they are directly connected with one's business of actively managing the enterprise.⁴⁰⁴

The expense of bringing a stockholder's bill on behalf of a corporation would not be deductible unless the stockholder was actively engaged in managing the corporation or in managing his investments and the action was directly connected with such management, for a stockholder, merely as such, is not engaged in business. But if, by court order, the corporation pays the expense of such a suit in its behalf, the corporation may deduct such expense if the suit is connected with its current business.⁴⁰⁵ The corporation's expenses in resisting such an action would also be deductible, since such actions are an ordinary risk of business.⁴⁰⁶

It has been held that when the result of a suit against a corporation will directly and substantially affect an active officer or employee (other than

⁴⁰²As stated *supra* notes 364 and 379, a corporate officer or employee is engaged in business as such, and expenses arising out of that status are his business expenses. Respecting expenses incurred by such officers solely in their capacity as stockholders, arising from the corporation's business and not from the officer's business of management, see *Deputy v. du Pont*, 308 U. S. 488, 60 Sup. Ct. 363 (1940).

So far as an attorney's fee paid by a corporation represents services rendered to a predecessor corporation, it is a capital expenditure representing a cost of the corporate assets acquired by the successor. *Pidgeon-Thomas Iron Co.*, 27 B. T. A. 642 (1933). The rule may be otherwise if the identity of the corporation is substantially unchanged and the obligation was assumed by operation of law. *Supra* note 295.

Respecting torts by corporate officers, see *supra* note 379; *quo warranto* proceedings, see *supra* note 381; violations of anti-trust acts, see *supra* notes 397, 398 and 399.

⁴⁰³*Crowley v. Comm'r*, 89 F. (2d) 715 (C. C. A. 6th 1937) (minority stockholder's action against taxpayer for mismanagement; taxpayer settled by having corporation retire plaintiff's stock; although taxpayer then had no more shares, his proportionate interest was greater; held, legal fees not deductible); *Laemmle v. Eisner*, 275 Fed. 504 (S. D. N. Y. 1920) (taxpayer got another stockholder to sell out to him in violation of contract with a third party; third party sued; taxpayer kept stock in settlement; attorney fee held capital expenditure); *Dwight W. Williamson*, 17 B. T. A. 1112 (1929). Cf. *Newark Milk & Cream Co.*, 23 B. T. A. 14 (1931) (taxpayer paid opponent's attorney fees as part of settlement).

⁴⁰⁴*S. Cupples Scudder, Exec'r*, 22 B. T. A. 1294 (1931) (NA) (similar to *Laemmle* case, *supra* note 403, except that taxpayer did not keep contested stock; held, deductible loss); *Charles J. Weber*, B. T. A. Mem. Docket No. 85429, July 29, 1938, 1938-4 C. C. H. ¶ 7319-F (*defense of management, protecting position as officer; deductible*). Cf. *Samuel D. Leidesdorf*, 26 B. T. A. 881 (1932) (A) (seller of stock to taxpayer unsuccessfully alleged agreement to hold it in trust; legal expense deductible).

⁴⁰⁵*Udolpho Wolfe Co.*, 15 B. T. A. 485 (1929) (A) (Board found that, by Rhode Island law, equity court had power to make such an order).

⁴⁰⁶*O'Day Investment Co.*, 13 B. T. A. 1230 (1928) (A). See 3 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 23.51.

in his capacity as a stockholder), as, for example, by substituting a receiver for his management and depriving him of his position, legal expenses personally incurred by him in opposing the suit are deductible by him as expenses of *his* business.⁴⁰⁷ However, the legal and other expenses incurred by a deposed officer in carrying his case to the stockholders are not deductible, at least if he is "acting solely in the interest of the corporation and its stockholders," and disclaims the motive of regaining his position.⁴⁰⁸ If a corporation assumes the expense of defending a suit against an officer or director, not arising out of the ordinary business of the corporation, the expense is, of course, not deductible, even though the suit may have impaired the prestige and good will of the corporation or prevented its officer from giving full attention to its management.⁴⁰⁹

The legal and other expenses connected with the organization of a corporation, its reorganization, its reincorporation in another jurisdiction, and the amendment of its charter are capital expenditures and may not be deducted as business expenses.⁴¹⁰ Nor may they be added to the cost basis of any physical property of the corporation, to be recovered by depreciation or from the proceeds of a sale.⁴¹¹ However, it has been held that such expenses

⁴⁰⁷E. L. Potter, 20 B. T. A. 252 (1930) (NA).

⁴⁰⁸Ralph C. Holmes, 37 B. T. A. 865 (1938). The Board held that he had been engaged in the business of managing the corporation but the campaign carried on after he resigned was not proximately connected with it. Although he remained as a director, the Board avoided opinion whether that was a business in his case, for it was an extraordinary, not an ordinary, expense for a director to conduct such a campaign out of his own pocket. The Board expressed no opinion on what the rule would be if he had not disclaimed the motive of regaining his position.

⁴⁰⁹Forty-Four Cigar Co., 2 B. T. A. 1156 (1925) (family fight); Blackwell Oil & Gas Co., 20 B. T. A. 661 (1930), *aff'd*, 60 F. (2d) 257 (C. C. A. 10th 1932) (alleged conspiracy by directors to prevent performance of contract for transfer of stock); San-Knit-Ary Textile Mills, Inc., 22 B. T. A. 754 (1931) (automobile accident; corporation defended officer, but no evidence that he had been driving on its business; corporation was not sued, but feared it would be); George D. Mann, 33 B. T. A. 281 (1935) (divorce). *But cf.* Matson Navigation Co., 24 B. T. A. 14 (1931) (conspiracy suit against stockholders of corporation; they conducted unified defense through corporation and paid legal expenses by checks to corporation, which paid attorney; legal expenses were actually borne by stockholders who were sued, and *they* may deduct since suit arose out of their business).

⁴¹⁰Guarantee Bond & Mortgage Co. v. Comm'r, 44 F. (2d) 297 (C. C. A. 6th 1930) (organization expense); Emerson Electric Mfg. Co., 3 B. T. A. 932 (1926) (A) (amendment of charter); Weber-Bunke-Lange Coal Co., 11 B. T. A. 503 (1928) (A) (reorganization); Clarence Whitman & Sons, Inc., 11 B. T. A. 1192 (1928) (A) (organization); Udolpho Wolfe Co., 15 B. T. A. 485 (1929) (A) (reincorporation in Holland); W. P. Brown & Sons Lumber Co., 26 B. T. A. 1192 (1932), *appeal dismissed*, 68 F. (2d) 1022 (C. C. A. 6th 1934) (organization); Pacific Coast Biscuit Co., 32 B. T. A. 39 (1935) (A) (amendment of charter); T. D. 2499 (Int. Rev. 1917) (organization).

It should be noted, in this connection, that *taxes* are deductible even though connected with capital transactions, but *fees* are not. Logan-Gregg Hardware Co., 2 B. T. A. 647 (1925) (held to be a fee); Clarence Whitman & Sons, Inc., *supra* (A) (tax); Borg & Beck Co., 24 B. T. A. 995, 1004 (1931) (A) (tax).

⁴¹¹Hotel de France Co., 1 B. T. A. 28 (1924); Malta Temple Ass'n, 16 B. T. A. 409 (1929) (A); T. D. 2499 (Int. Rev. 1917).

are the cost of an intangible asset, the corporate franchise, and may be taken as a loss upon the dissolution of the corporation⁴¹² or written off over the life of the corporation if its existence is limited.⁴¹³ On the other hand, organization expenses are not deductible as a loss upon the *merger* of the corporation, for its corporate rights and powers are not extinguished but live on in the merging corporation.⁴¹⁴

The expenses connected with a merger or consolidation of corporations are also not deductible by either corporation as ordinary and necessary business expenses,⁴¹⁵ although it has been held that the expenses are immediately deductible as a loss or expense if the project is abandoned.⁴¹⁶

The expenses of dissolution and liquidation are also held not to be ordinary and necessary business expenses,⁴¹⁷ and it has also been declared that they may not be deducted at any time as a loss.⁴¹⁸

⁴¹²*Malta Temple Ass'n*, 16 B. T. A. 409 (1929) (A); *Pacific Coast Biscuit Co.*, 32 B. T. A. 39 (1935) (A); *Liquidating Co.*, 33 B. T. A. 1173 (1936) (NA). The Board held in the *Liquidating Co.* case that the loss was incurred when statutory dissolution was completed and the corporation could no longer carry on business, even though it remained in existence for the purpose of winding up its affairs. On the other hand, no loss may be claimed until dissolution is effected, even though the corporation has voted to liquidate and is selling out. *City & Suburban Mortgage Co.*, 22 B. T. A. 179 (1932).

Cf. Odorono Co., 26 B. T. A. 1355 (1932) (organization expenses disallowed as a loss on dissolution in absence of evidence that a loss was actually suffered upon the transfer to a successor company).

⁴¹³*Hershey Mfg. Co. v. Comm'r*, 43 F. (2d) 298 (C. C. A. 10th 1930). The Board has refused to follow that rule. *Surety Finance Co. of Tacoma*, 27 B. T. A. 616 (1933), *aff'd on other grounds*, 77 F. (2d) 221 (C. C. A. 9th 1935).

⁴¹⁴*Motion Picture Capital Corp. v. Comm'r*, 80 F. (2d) 872 (C. C. A. 2d 1936); *Citizens Trust Co.*, 20 B. T. A. 392 (1930) (involved New York law on effect of merger).

⁴¹⁵*Motion Picture Capital Corp. v. Comm'r*, 80 F. (2d) 872 (C. C. A. 2d 1936); *Beneficial Industrial Loan Corp. v. Handy*, 92 F. (2d) 74 (C. C. A. 3d 1937); *First National Bank of St. Louis*, 3 B. T. A. 807 (1926); *Odorono Co.*, 26 B. T. A. 1355 (1932); *Clara B. Parker, Exec'x*, 30 B. T. A. 1231, 1248 (1934), *appeal dismissed*, 75 F. (2d) 1010 (C. C. A. 9th 1935).

Presumably the expenses would be recoverable in the same manner as organization expenses. *See First National Bank of St. Louis*, 3 B. T. A. 807, 808 (1926). *But cf. Odorono Co.*, 26 B. T. A. 1355 (1932) (*supra* note 412).

⁴¹⁶*Portland Furniture Mfg. Co.*, 30 B. T. A. 878 (1934) (NA) (held to be a loss even though attorney's reports on abandoned merger were later used as starting point for new, successful negotiations); *Doernbecher Mfg. Co.*, 30 B. T. A. 973, 986 (1934) (A) (called an *expense*).

⁴¹⁷*Odorono Co.*, 26 B. T. A. 1355 (1932); *Ernest DuPont*, 34 B. T. A. 1059, 1061 (1936) (the facts are found in 33 B. T. A. 643 (1935), which was reversed upon reconsideration), *aff'd sub nom. Pier v. Comm'r*, 96 F. (2d) 642 (C. C. A. 9th 1938); *State ex rel. Gibson v. American Bonding & Casualty Co.*, 225 Iowa 638, 281 N. W. 172 (1938) (attorney for liquidating receiver).

Contra: Pacific Coast Biscuit Co., 32 B. T. A. 39, 42 (1935) (NA), holding that since no asset was acquired or protected through the expenditures in dissolution, they are not capital expenditures; and, although (like a lawsuit) it may occur only once in the business life of a particular taxpayer, dissolution and the expenses thereof are normal incidents of the business world and the expense is deductible. *Cf. Welch v. Helvering*, 290 U. S. 111, 114, 54 Sup. Ct. 8 (1933).

⁴¹⁸*See Odorono Co.*, 26 B. T. A. 1355 (1932); *Pacific Coast Biscuit Co.*, 32 B. T. A.

The expenses connected with the corporate franchise must be carefully segregated and distinguished from those relating to the capital structure. The latter are no more deductible currently than the former,⁴¹⁹ but it is also invariably held that the expenses of issuing stock, changing its par, and the like, may not be amortized over the life of the stock or of the corporation⁴²⁰ and may not be taken as a loss at any time;⁴²¹ on the other hand, the expenses of issuing bonds may be amortized, at least on the accrual basis.⁴²²

It has been held, however, that when an attorney is regularly employed on a salary as the general counsel for a corporation, even though a part

39, 42 (1935). The former case went off on failure to prove that the transaction was not beneficial; the latter rested upon the fact that the expenses were not incurred in the acquisition or intended acquisition of any asset which could be the subject of a loss, but the dictum is weakened because it was held to be a deductible *expense* in any event; furthermore, it is not always required that a loss be related to the cost of some asset. See *supra* note 222.

⁴¹⁹*Simmons Co. v. Comm'r*, 33 F. (2d) 75 (C. C. A. 1st 1929), *cert. denied*, 280 U. S. 588, 50 Sup. Ct. 37 (1929); *Corning Glass Works v. Comm'r*, 37 F. (2d) 798, 59 App. D. C. 168 (1929), *cert. denied*, 281 U. S. 742, 50 Sup. Ct. 348 (1930); *Logan-Gregg Hardware Co.*, 2 B. T. A. 647 (1925); *Emerson Electric Mfg. Co.*, 3 B. T. A. 932 (1926); *Holeproof Hosiery Co.*, 11 B. T. A. 547 (1928); *Borg & Beck Co.*, 24 B. T. A. 995, 1004 (1931) (A) (changing stock from par to no par, and floating new stock); *Commercial Investment Trust Corp.*, 28 B. T. A. 143 (1933) (A), *aff'd w. o. op.*, 74 F. (2d) 1015 (C. C. A. 2d 1935); *James I. Van Keuren*, 28 B. T. A. 480 (1933); *I. T. 1198*, I-1 CUM. BULL. 275 (1922); *A. R. R. 6048*, III-1 CUM. BULL. 293 (1924). All the cases cited involved legal or other expenses of floating stock. The same is held of the cost of floating a loan. *W. P. Brown & Sons Lumber Co.*, 26 B. T. A. 1192 (1932), *appeal dismissed*, 68 F. (2d) 1022 (C. C. A. 6th 1934); see *Helvering v. Union Pacific R.R.*; 293 U. S. 282, 286, 55 Sup. Ct. 165 (1934).

⁴²⁰*Barbour Coal Co. v. Comm'r*, 74 F. (2d) 163 (C. C. A. 10th 1934), *cert. denied*, 295 U. S. 731, 55 Sup. Ct. 643 (1935); *Surety Finance Co. v. Comm'r*, 77 F. (2d) 221 (C. C. A. 9th 1935); *Columbian Nat. Fire Ins. Co. v. United States*, 9 F. Supp. 688, 695, 80 Ct. Cl. 622, 638 (1935); *Commercial Investment Trust Corp.*, 28 B. T. A. 143 (1933) (A), *aff'd w. o. op.*, 74 F. (2d) 1015 (C. C. A. 2d 1935).

It is held that no wasting asset is acquired by such expenditures with respect to which an allowance for exhaustion may be taken under Internal Revenue Code § 23 (I). The fact that the stockholders expect to get their investment back at a certain time does not convert the cash received into a wasting asset, and there is no other asset against which the expenses can be applied.

⁴²¹*American Loan Co. v. Handy*, 16 F. Supp. 107 (D. Del. 1936), *aff'd w. o. op.*, 92 F. (2d) 74 (C. C. A. 3d 1937) (not deductible when consolidated); *James I. Van Keuren*, 28 B. T. A. 480 (1933) (not a loss upon dissolution); *Pacific Coast Biscuit Co.*, 32 B. T. A. 39 (1935) (A) (same); *I. T. 1198*, I-1 CUM. BULL. 275 (1922) (not a loss upon redemption).

The regulations, impliedly approved by the Congress by repeated re-enactment of the statute without change, provide, in effect, that no gain or loss is realized upon the issuance of stock, nor upon the reacquisition thereof, unless the corporation is trading in it. Regulations 103, sec. 19.22 (a)-16.

⁴²²*Helvering v. Union Pacific R.R.*, 293 U. S. 282, 55 Sup. Ct. 165 (1934). The same result should follow on the cash basis, with respect to attorney fees, for even on that basis capital expenditures must be spread over the period in which the benefits are enjoyed. Cf. *I. T. 3251*, 1939-1 CUM. BULL. 113.

Although logically the rule of the above case might apply equally to stock issues, the distinction is rested upon the regulations as impliedly approved by the Congress (*supra* note 421). *Columbian Nat. Fire Ins. Co. v. United States*, 9 F. Supp. 688, 696, 80 Ct. Cl. 622, 639 (1935).

of his services are of a capital nature, his salary is currently deductible.⁴²³

The deductibility of legal expenses connected with the ownership and use of property depends not only upon proximate relation to business but upon the distinction between current and capital expenditures. Of course, if the matter does not arise from trade or business, the expenses are not deductible in any event.⁴²⁴ If the expenses are connected with trade or business, deduction may nevertheless be denied if the payment is considered to be in the nature of a capital expenditure, which must be capitalized as part of the cost of the property.

Thus, it is settled that the legal and other expenses connected with the *obtaining* of property are not currently deductible, whether the taxpayer is on the cash or the accrual basis, and whether or not the taxpayer is in the business of buying and selling such property, but such expenditures must be added to the cost of the property.⁴²⁵ Similarly, the attorney's fees incident to procuring a leasehold must be capitalized and deducted over the life of the lease.⁴²⁶ If, however, the property is not acquired or the lease is not

⁴²³Saks & Co., 20 B. T. A. 1151 (1930) (NA).

⁴²⁴Will contests and construction suits are personal matters even though business property may be involved. *Merriman v. Comm'r*, 55 F. (2d) 879 (C. C. A. 1st 1932) (taxpayer very frankly claimed expense as a loss in a "transaction entered into for profit," but the court held that a successful will contest would obtain for him only what was found justly his, and no "profit" could be anticipated from the transaction); *Lansill v. Burnet*, 58 F. (2d) 512, 61 App. D. C. 107 (1932); *Hutchings v. Burnet*, 58 F. (2d) 514, 61 App. D. C. 109 (1932); *George P. and Bessie P. Douglas*, 1 B. T. A. 372 (1925); I. T. 1689, II-1 CUM. BULL. 122 (1923); *United States Trust Co., Exec'r*, 27 B. T. A. 1260 (1933) (legatee's defense of will contest); A. R. R. 284, 3 CUM. BULL. 208 (1920) (same); *George Vanderbilt Trust*, 36 B. T. A. 967 (1937) (will construction suit); *Gloria Laura Morgan Vanderbilt*, 39 B. T. A. 43 (1939), *aff'd w. o. op.*, 107 F. (2d) 1023 (C. C. A. 2d 1939), *cert. denied*, 309 U. S. 683, 60 Sup. Ct. 723 (1940) (same).

Other instances include *Croker v. Burnet*, 62 F. (2d) 991, 61 App. D. C. 342 (1933) (stepson's suit to set aside transfer by deceased father to second wife; although it was business property, suit did not arise from business); *Croker v. Helvering*, 91 F. (2d) 299, 67 App. D. C. 226 (1937) (attorney's fee connected with sale of non-business property); *Fred J. Hughes*, 1 B. T. A. 944 (1925) (recovering personal stock of liquors seized by police; not a loss from "casualty"); *Thomas F. Gurry*, 27 B. T. A. 1237 (1933) (prosecution before Mixed Claims Commission of claim for seizure of pleasure car in Germany).

⁴²⁵*Helvering v. Winnill*, 305 U. S. 79, 59 Sup. Ct. 45 (1938); *Seletha O. Thompson*, 9 B. T. A. 1342 (1928) (A); *Stephens Fuel Co.*, 13 B. T. A. 666 (1928) (A) (denied attempt to write off the expense over arbitrary ten-year period, since not an exhaustible asset); *W. P. Brown & Sons Lumber Co.*, 26 B. T. A. 1192 (1932), *appeal dismissed*, 68 F. (2d) 1022 (C. C. A. 6th 1934) (fee for examining title, recording deed, etc.); I. T. 1689, II-1 CUM. BULL. 122 (1923); G. C. M. 15430, XIV-2 CUM. BULL. 59 (1935) (even dealers and traders must capitalize purchase commissions).

⁴²⁶*Meyram v. Comm'r*, 63 F. (2d) 986 (C. C. A. 3d 1933) (cash basis); *Griffiths v. Comm'r*, 70 F. (2d) 946 (C. C. A. 7th 1934) (spread over 99-year lease); *Sigmund Spitzer*, 23 B. T. A. 776 (1931); *Watson P. Davidson*, 27 B. T. A. 158 (1932); *Edward T. Blair*, 31 B. T. A. 1192, 1205 (1935), *rev'd on other grounds*, 83 F. (2d) 655 (C. C. A. 7th 1936), *rev'd on other grounds*, 300 U. S. 5, 57 Sup. Ct. 330 (1937) (when trustee makes such expenditures, "distributable" income taxable to the beneficiary may not be

entered into, the attorneys' fees preparatory thereto have been held currently deductible if connected with one's trade or business.⁴²⁷

In the treatment of legal and other expenses incurred in connection with the sale or other disposition of property, there is serious disagreement. Fundamentally, the expenses of a sale, like those of a purchase, are of a capital nature, chargeable against the profit on the transaction, or increasing the loss therefrom. But where the detail of accounting on that basis, allocating expenses to every sale, would be so burdensome as to be impracticable, the Bureau makes an exception and permits accounting for *selling* expenses as ordinary business expenses. The Bureau confines the exception strictly to dealers,⁴²⁸ but the cases have extended it to anyone in the business of buying and selling, including traders and active investors.⁴²⁹ Of course, for those not engaged in the business, selling expenses must be capitalized.⁴³⁰ Legal

reduced by the amount thereof, except over term of lease; in effect, for income tax purposes, such expenses are charged to corpus, whatever is in fact done by the trustee).

⁴²⁷*Selettha O. Thompson*, 9 B. T. A. 1342 (1928) (A); *Watson P. Davidson*, 27 B. T. A. 158 (1932) (NA). Cf. *S. Cupples Scudder, Exec'r*, 22 B. T. A. 1294 (1931) (NA) (protection of option which others sought to have declared void; when lost suit, held, a business loss, for no property was acquired through the expenditures).

If the intended purchase or lease was not connected with business but was for an investment, no deduction is permitted. It is not a loss in a "transaction entered into for profit," since the transaction was not entered. *Robert Lyons Hague*, 24 B. T. A. 288 (1931); *Estate of Henry N. Brawner*, 36 B. T. A. 884 (1937).

⁴²⁸*T. 2305, V-2 CUM. BULL.* 108 (1926) (real estate dealer); *G. C. M.* 15430, XIV-2 CUM. BULL. 59 (1935) (securities). Since neither a trader (speculator) nor an investor is permitted to account on an *inventory* basis (Regulations 103, sec. 19.22 (c)-5), no added burden is placed on them by requiring separate accounting for the expenses of each transaction. For the distinction between a trader and a dealer, see *Trading Associates Corp. v. Magruder*, 112 F. (2d) 779 (C. C. A. 4th 1940); Regulations 103, sec. 19.22 (c)-5; *G. C. M.* 9656, X-2 CUM. BULL. 127 (1931); *G. C. M.* 9958, X-2 CUM. BULL. 158 (1931).

⁴²⁹*Winmill v. Comm'r*, 93 F. (2d) 494 (C. C. A. 2d 1937), *rev'd on other grounds*, 305 U. S. 79, 59 Sup. Ct. 45 (1938) (trader); *Neuberger v. Comm'r*, 104 F. (2d) 649 (C. C. A. 2d 1939), *rev'd on other grounds*, 61 Sup. Ct. 97 (1940) (trader); *J. W. Forgeus*, 6 B. T. A. 291 (1927) (A) (real estate developer; expense of defending action for commissions on sale); *Adolph B. Spreckels*, 41 B. T. A. 1204 (1940) (NA) (securities trader); *Alice du Pont Ortiz*, 42 B. T. A. 173 (1940) (NA) (active investor); *George W. Covington*, 42 B. T. A. 601 (1940) (trader on commodities exchange). Cf. *Smith v. Russell*, 76 F. (2d) 91 (C. C. A. 8th 1935), *cert. denied*, 296 U. S. 614, 56 Sup. Ct. 131 (1935) (sale not completed until year after attorney's fee was paid; although taxpayer was not in business of selling property, expense was held deductible only when paid, and not to be deducted from sale price).

⁴³⁰*Dalriada Realty Co.*, 5 B. T. A. 905 (1926) (A) (expenses of sale to be spread over period for which profits reported, on installment basis); *Hannibal Missouri Land Co.*, 9 B. T. A. 1072 (1928) (expenses of surveying land for sale not deductible until sale); *W. A. Bahr*, 10 B. T. A. 637 (1928) (A); *Mrs. E. A. Giffin*, 19 B. T. A. 1243 (1930) (like *Dalriada* case); *Odorono Co.*, 26 B. T. A. 1355 (1932) (expenses of sale of property in non-taxable reorganization); *Victoria Paper Mills Co.*, 32 B. T. A. 666 (1935), *aff'd w. o. op.*, 83 F. (2d) 1022 (C. C. A. 2d 1936) (sale not completed until year after attorney fee paid; not deductible in year of payment); *I. T. 2305, V-2 CUM. BULL.* 108 (1926); *I. T. 2340, VI-1 CUM. BULL.* 43 (1927). See also *infra* note 432. But cf. *Smith v. Russell*, *supra* note 429 (attorney fee connected with sale of corporate property by one not a dealer, held a business expense).

expenses connected with leasing the taxpayer's property are held to be capital expenditures, to be amortized over the term of the lease, even though the taxpayer's business is leasing such property.⁴³¹

The expense of contesting the amount of an award in condemnation proceedings is a capital expenditure to be offset against the award in determining gain or loss.⁴³² On the other hand, the expense of successfully resisting condemnation as unconstitutional has been held to be a current expense, deductible if sustained in trade or business, since no sale resulted and the taxpayer's title was not questioned.⁴³³ The expenses of getting a special assessment reduced have also been held to be current rather than capital expenditures, but the Bureau takes a contrary view.⁴³⁴

It is well established that the cost of defending or perfecting title is a capital expenditure and may not be currently deducted.⁴³⁵ It is generally

⁴³¹Comm'r v. Chicago Dock & Canal Co., 84 F. (2d) 288 (C. C. A. 7th 1936), *aff'd* 32 B. T. A. 231 (1935) (not currently deductible even though taxpayer's sole business was leasing its property and many leases were made); I. T. 3251, 1939-1 CUM. BULL. 113 (same rule on cash basis).

⁴³²Williams v. Burnet, 59 F. (2d) 357, 61 App. D. C. 181 (1932); Washington Market Co., 25 B. T. A. 576 (1932) (A).

⁴³³L. B. Reakirt, 29 B. T. A. 1296 (1934), *aff'd w.o. op.*, 84 F. (2d) 996 (C. C. A. 6th 1936).

⁴³⁴Comm'r v. Chicago Dock & Canal Co., 84 F. (2d) 288 (C. C. A. 7th 1936), *aff'd* 32 B. T. A. 231 (1935) (NA). *Contra*: O. D. 739, 3 CUM. BULL. 192 (1920).

⁴³⁵Regulations 103, sec. 19.24-2; Murphy Oil Co. v. Burnet, 55 F. (2d) 17, 25 (C. C. A. 9th 1932), *aff'd on other grounds*, 287 U. S. 299, 53 Sup. Ct. 161 (1932) (defense of vendor's suit to rescind for fraud); Hutchings v. Burnet, 58 F. (2d) 514, 61 App. D. C. 109 (1932) (defense of title); Croker v. Burnet, 62 F. (2d) 991, 61 App. D. C. 342 (1933) (defense of suit to set aside transfer by alleged incompetent); Brawner v. Burnet, 63 F. (2d) 129, 61 App. D. C. 352 (1933) (similar); Moynier v. Welch, 97 F. (2d) 471 (C. C. A. 9th 1938) (defense of right to oil royalties); Consolidated Mutual Oil Co., 2 B. T. A. 1067 (1925); Frederick McLean Bugher *et al.*, Exec'rs, 9 B. T. A. 1155 (1928) (A); North American Oil Consolidated, 12 B. T. A. 68, 94 (1928) (A), *rev'd on other grounds*, 286 U. S. 417, 52 Sup. Ct. 613 (1932); Phoenix Development Co., 13 B. T. A. 414 (1928); O. J. Morrison, 19 B. T. A. 635, 638 (1930); Esther Rentie, 21 B. T. A. 1230 (1931); A. R. R. 284, 3 CUM. BULL. 208 (1920) (defense of claim by decedent's partner that devised property was bought with firm funds); S. M. 2423, III-2 CUM. BULL. 157 (1924).

But cf. Samuel D. Leidesdorf, 26 B. T. A. 881 (1932) (A) (successful defense against claim of seller that taxpayer had agreed to hold in trust for him; expense held currently deductible); Grace McBride Crile, 26 B. T. A. 1020 (1932) (NA) (defense of trust against invalidation under rule against perpetuities, held deductible); Langford Investment Co., 28 B. T. A. 222 (1933) (NA), *aff'd on other grounds*, 77 F. (2d) 468 (C. C. A. 5th 1935) (holding that defense of suit to set aside fraudulent transfer is not a defense of title and is currently deductible). See six-member dissent in Alice P. Bachofen von Echt, 21 B. T. A. 702, 709 (1930), arguing that all the "defense of title" cases were overruled by Kornhauser v. United States, 276 U. S. 145, 48 Sup. Ct. 219 (1928) (relating to defense of right to previously-earned income), and that legal expenses should be currently deductible if they serve to maintain only what the taxpayer has instead of adding to his rights. Long-standing Congressional acquiescence in the regulations, however, militates against this view. See Williams v. Burnet, 59 F. (2d) 357, 61 App. D. C. 181 (1932).

Although patent litigation may be, in effect, a defense of title to the patent, expenses of such actions, other than interference proceedings, are held not to be capital expenditures. See *supra* note 375.

held that such expenditures may be added to the cost basis of the property,⁴³⁶ although occasionally that has been doubted by the courts and the Board, on the ground that the defense of title adds nothing to the value of the property.⁴³⁷ There is some authority to the effect that, when the right to retain the interim income is involved in the title suit, the attorney fee may be currently deducted so far as it is allocable to the defense of the right to retain the income, if evidence is available from which such an apportionment can be made.⁴³⁸

The expenses of examining title,⁴³⁹ as well as the cost of registration of title under the Torrens system,⁴⁴⁰ even though connected with one's business, are capital expenditures, not currently deductible. The same is true of the expense of the partition of property.⁴⁴¹

The expenses of an action to recover property which had been seized have been held to be currently deductible if connected with trade or business, since no title question is involved, although the question cannot be said to be settled.⁴⁴² Of course, if the matter is not connected with one's business,

⁴³⁶Charles P. Hewes, 2 B. T. A. 1279 (1925); West End Consolidated Mining Co., 3 B. T. A. 128 (1925) (A); North American Oil Consolidated, 12 B. T. A. 68, 94 (1928) (A), *rev'd on other grounds*, 286 U. S. 417, 52 Sup. Ct. 613 (1932) (attorney fee written off in depletion); Ida Wolf Schick, 22 B. T. A. 1067 (1931) (defense of life estate, written off over life expectancy); R. S. Goforth, 32 B. T. A. 1206 (1935) (NA), *appeals dismissed*, 84 F. (2d) 1003 and 86 F. (2d) 1000 (C. C. A. 10th 1936). Cf. Lido Bldg. Co., Inc., 31 B. T. A. 461 (1934) (A) (amount given person who financed defense of leasehold against attack, held additional cost of lease).

Cf. Internal Revenue Code § 113 (b) (1) (A), providing that there shall be added to the basis any expenditures "properly chargeable to capital account."

But if the basis used is not cost but the *value* of a *good* title on March 1, 1913, or at date of acquisition (see *supra* note 195), the cost of defending that title may not be added to the basis even though incurred subsequent to the date to which the value relates. *Murphy Oil Co. v. Burnet*, 55 F. (2d) 17, 26 (C. C. A. 9th 1932), *aff'd on other grounds*, 287 U. S. 299, 53 Sup. Ct. 161 (1932).

⁴³⁷*R. E. Nail et al.*, Exec'rs, 27 B. T. A. 33 (1932) (A) (expense of boundary dispute held neither currently deductible nor added to cost, for expenditure did not serve to enlarge, change, or acquire for the taxpayer any interest in property). Cf. *Comm'r v. Field*, 42 F. (2d) 820, 822 (C. C. A. 2d 1930), in which Judge Learned Hand said that the judgments of a court do not create rights but only declare and protect rights which the party had already, and hence the expenses of defending title do not add value to the property and may not be capitalized.

⁴³⁸*Frederick McLean Bugher et al.*, Exec'rs, 9 B. T. A. 1155 (1928) (A); *but see* *Murphy Oil Co. v. Burnet*, 55 F. (2d) 17, 26 (C. C. A. 9th 1932), *aff'd on other grounds*, 287 U. S. 299, 53 Sup. Ct. 161 (1932) (expressing doubt that apportionment would be permitted even if proper evidence had been presented).

⁴³⁹*W. P. Brown & Sons Lumber Co.*, 26 B. T. A. 1192 (1932), *appeal dismissed*, 68 F. (2d) 1022 (C. C. A. 6th 1934).

⁴⁴⁰*Lincoln L. McCandless*, 5 B. T. A. 1114 (1927).

⁴⁴¹*Lincoln L. McCandless*, 5 B. T. A. 1114 (1927); *Charles J. Livingood*, Exec'r, 25 B. T. A. 585 (1932).

⁴⁴²*Comm'r v. Speyer*, 77 F. (2d) 824 (C. C. A. 2d 1935), *aff'g* 30 B. T. A. 517 (1934). *cert. denied*, 296 U. S. 631, 56 Sup. Ct. 155 (1935); *Comm'r v. Ullmann*, 77 F. (2d) 827 (C. C. A. 2d 1935), *cert. denied*, 296 U. S. 631, 56 Sup. Ct. 155 (1935). Those cases involved bank accounts confiscated by the Germans, and a different result

the expenses are not deductible.⁴⁴³ An expense incurred to evict trespassers not claiming title, which expense thus serves to protect the present enjoyment of the property rather than its ownership, is also held currently deductible if it relates to one's business.⁴⁴⁴ For the same reason, the expenses of procuring the appointment of a receiver to prevent one's defaulting tenant from continuing to collect rents from sublessees is a current expense.⁴⁴⁵ Likewise the expense of procuring the forfeiture of a lease for the lessee's default is held currently deductible.⁴⁴⁶

There is no agreement with respect to expenses incurred in defense of one's right to make what use he chooses of his property. The expense of contesting a city's establishment of a building line has been ruled to be a capital expenditure.⁴⁴⁷ On the other hand, the cost of the defense of a suit for an injunction to restrain taxpayer's proposed use of his land is a current expense.⁴⁴⁸

The expenses of a mortgagee in foreclosing, at least if he acquires the property thereby, are capital expenditures.⁴⁴⁹ But the expense of defending the attempted foreclosure of mechanics' liens is currently deductible if connected with business, since it is incurred by the building owner in order to avoid paying a contractor's debts and not to protect his title to property.⁴⁵⁰ Similarly, the expense of bringing a proceeding to set aside a fraudulent conveyance of property, having the primary object of collecting a business debt, is deductible, at least if it is cash rather than the property which the taxpayer obtains thereby.⁴⁵¹

might follow if physical property or securities were involved. In *Alice P. Bachofen von Echt*, 21 B. T. A. 702 (1930), it was held that the expenses of regaining securities seized by the Germans were *not* deductible; but the case was reconsidered and reversed in an unpublished memorandum, which is quoted with approval in *Kales v. Comm'r*, 101 F. (2d) 35, 38 (C. C. A. 6th 1939).

Contra: O. D. 1048, 5 CUM. BULL. 127 (1921).

⁴⁴³The expense is not a loss from "casualty." *Fred J. Hughes*, 1 B. T. A. 944 (1925); *Thomas F. Gurry*, 27 B. T. A. 1237 (1933).

⁴⁴⁴*Bliss v. Comm'r*, 57 F. (2d) 984 (C. C. A. 5th 1932).

⁴⁴⁵*Milton H. Friend et al., Trustees*, 40 B. T. A. 767 (1939) (A).

⁴⁴⁶*Mary E. Evans*, 42 B. T. A. 246 (1940) (NA) (held to be a loss incident to default on contract; distinguished from payments made to purchase cancellation, which must be amortized).

⁴⁴⁷*I. T. 1382*, 1-2 CUM. BULL. 146 (1922).

⁴⁴⁸*Memphis Memorial Park*, 28 B. T. A. 1037 (1933) (A), *aff'd w. o. op.*, 84 F. (2d) 1008 (C. C. A. 6th 1936). *But cf.* *Richard G. Babbage et al., Exec'rs*, 27 B. T. A. 57 (1932), in which the injunction suit was founded upon a restrictive covenant which the taxpayer had violated by leasing his land for business purposes; the equity court balanced the equities (the covenant was soon to expire) and allowed the lease to stand; held to be a capital expenditure, to be spread over the life of the lease.

⁴⁴⁹*Hadley Falls Trust Co. v. United States*, 110 F. (2d) 887, 893 (C. C. A. 1st 1940); *Commonwealth Life Insurance Co.*, 31 B. T. A. 887, 892 (1935), disapproving *E. S. Briant, Adm'r*, 6 B. T. A. 651 (1927) (NA).

⁴⁵⁰*Lena G. Hill*, 8 B. T. A. 1159 (1927) (A).

⁴⁵¹*See Swastika Oil & Gas Co.*, 40 B. T. A. 797 (1939) (A) (Commissioner only sought to tax net recovery after legal expenses).

It cannot be overemphasized that an attorney performing a variety of services for his client should itemize his fees and make available to his client the evidence upon which the apportionment is based. For in many cases taxpayers, who have the burden of showing how much of an attorney's fee is of a deductible kind, have been denied any deduction at all for want of such evidence.⁴⁵²

The year in which legal expenses may be deducted has frequently been considered. On the cash basis, of course, legal expenses (if currently deductible) are reported when paid.⁴⁵³ On the accrual basis, the deduction is taken when the fee becomes fixed or determinable, rather than spread

⁴⁵²Where both services of a personal nature and others connected with business were performed, and the fee was not apportioned, the entire expense was disallowed in *Sanderson v. Burnet*, 63 F. (2d) 268, 269, 61 App. D. C. 377 (1933) (single controversy involving business and personal matters); *Helen S. Pennell*, 4 B. T. A. 1039 (1926); *Arthur Jordan*, 12 B. T. A. 423 (1928); *Louis Kuhn*, 22 B. T. A. 975 (1931); *Bula E. Croker*, 27 B. T. A. 588 (1933); *Gloria Laura Morgan Vanderbilt*, 39 B. T. A. 43 (1939), *aff'd w. o. op.*, 107 F. (2d) 1023 (C. C. A. 2d 1939), *cert. denied*, 309 U. S. 683, 60 Sup. Ct. 723 (1940). Likewise, current deduction was denied when current and capital matters were not segregated, in *Murphy Oil Co. v. Burnet*, 55 F. (2d) 17, 26 (C. C. A. 9th 1932), *aff'd on other grounds*, 287 U. S. 299, 53 Sup. Ct. 161 (1932); *Crowley v. Comm'r*, 89 F. (2d) 715 (C. C. A. 6th 1937); *F. Tinker & Sons Co.*, 1 B. T. A. 799 (1925); *Peaslee-Gaulbert Co.*, 14 B. T. A. 769 (1928); *State ex rel. Gibson v. American Bonding & Casualty Co.*, 225 Iowa 638, 281 N. W. 172 (1938). Furthermore, no part of the expenditure may be added to the cost of property if capital items of proper nature cannot be segregated from others. *W. N. Stokes*, 7 B. T. A. 375 (1927). *Cf. Surety Finance Co. v. Comm'r*, 77 F. (2d) 221 (C. C. A. 9th 1935) (organization expenses not segregated from expense of issuing stock).

The Board apportioned an unitemized legal fee, upon being presented with sufficient evidence respecting the services, in *Frederick McLean Bugher et al., Exec'rs*, 9 B. T. A. 1155 (1928) (A), and *George W. Seligman, Exec'r*, 10 B. T. A. 840 (1928) (A). The circuit court remanded cases to the Board for such apportionment in *National Outdoor Adv. Bureau v. Helvering*, 89 F. (2d) 878 (C. C. A. 2d 1937) and *General Outdoor Adv. Co. v. Helvering*, 89 F. (2d) 882 (C. C. A. 2d 1937) (defense of anti-trust injunction suit, successful in respect to some charges, while other acts were enjoined; held, expenses should be apportioned). *Cf. Burnet v. Houston*, 283 U. S. 223, 228, 51 Sup. Ct. 413 (1931) (holding that the taxpayer is not relieved by impossibility of proof); *Cohan v. Comm'r*, 39 F. (2d) 540, 543-4 (C. C. A. 2d 1930) (holding that Board should make as close an approximation as it can, when it finds that an expense of undetermined amount has been made, but that all doubts may be resolved against the taxpayer). The Board applied the *Cohan* case to an unapportioned brokerage commission (analogous to an unapportioned legal fee) in *George W. Covington*, 42 B. T. A. 601 (1940).

The Board has allowed the entire salary of a corporation's general counsel, although part of his services concerned capital matters. *Saks & Co.*, 20 B. T. A. 1151 (1930) (NA). However, a *retainer* would probably be disallowed unless all the services concerned current business, since the lack of apportionment does not, in such a case, arise from necessity, a factor which influenced the Board in the *Saks* case. *Cf. 3 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION* (1934) § 23.65, n. 95. A retainer paid to an attorney by an active investor was held deductible in *O'Neal v. United States*, 32 F. Supp. 799 (M. D. Ga. 1940).

See also *supra* note 290, and Part One, notes 106 and 107.

⁴⁵³*Julia A. Strauss*, 2 B. T. A. 598 (1925); *Benjamin Paschal O'Neal*, 18 B. T. A. 1036 (1930) (A).

over the period in which the services are performed.⁴⁵⁴ When the fee is contingent, that time will normally be at the conclusion of the litigation, when all contingencies are removed and the facts upon which the amount will depend are available.⁴⁵⁵ However, when the amount of the fee is to depend upon services rendered, accrual is not permissible prior to the submission of a bill, even though the litigation is terminated, since the facts from which a reasonable estimate of the liability could be made are not available to the taxpayer.⁴⁵⁶ On the other hand, if legal expenses, or some part thereof, are actually fixed or paid prior to the termination of the litigation, they may be deducted without awaiting the conclusion of the suit.⁴⁵⁷

Summary

Legal expenses may be deducted, in general, only when connected with one's trade or business. The expenses of a criminal defense, even though connected with business, are deductible only if the defense is successful. Legal expenses connected with the acquisition or disposition of property or the protection of its title, or with other capital transactions, are not deductible but may in most instances be added to the cost of the property concerned, to be recovered through depreciation or depletion or through increasing the loss or decreasing the gain upon a sale.

⁴⁵⁴Noxon Chemical Products Co. v. Comm'r, 78 F. (2d) 871 (C. C. A. 3d 1935), *cert. denied*, 296 U. S. 647, 56 Sup. Ct. 307 (1936); Joshua C. Kelley, 38 B. T. A. 1292 (1938) (A); I. T. 2972, XV-1 CUM. BULL. 108, 109 (1936). See also cases cited *infra* notes 455-457. Cf. Regulations 103, sec. 19.42-1 (to effect that *income* from services is not accrued until compensation is determined).

⁴⁵⁵In Carey Van Fleet, 2 B. T. A. 825 (1925) (A), attorney was paid contingent fee when Supreme Court denied *certiorari*, but a motion to revoke that order was made within the year, so that litigation was not finally concluded; attorney (taxpayer) recognized that payment was premature and agreed to hold fee in trust pending outcome; held, not income in that year; by analogy, it would probably not be expense to client. But in Bonnie Bros., Inc., 15 B. T. A. 1231 (1929) (A), an action was apparently concluded in the taxable year, and taxpayer accrued contingent fee; subsequently, the matter was reopened and the recovery reduced; the fee was adjusted accordingly; held, all events to *fix* liability occurred in the taxable year, and *later* events cannot postpone accrual; but, since the tax liability for that year was still open, the *amount* was corrected to reflect the final result.

⁴⁵⁶Crown Cork & Seal Co. v. United States, 4 F. Supp. 525 (E. D. N. Y. 1933), *aff'd w. o. op.*, 73 F. (2d) 997 (C. C. A. 2d 1934); New Process Cork Co., 3 B. T. A. 1339 (1926); Joshua C. Kelley, 38 B. T. A. 1292 (1938) (A).

⁴⁵⁷F. Meyer & Bro. Co., 4 B. T. A. 481 (1926) (A).